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**A critical examination of Herbalife's business model in order to determine
whether it is a prohibited scheme under the Consumer Protection Act
68 of 2008**

by

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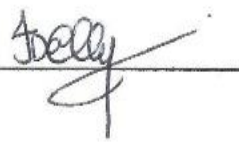
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DECLARATION

I, Johara Deen Ally, hereby declare that this dissertation, unless specifically indicated otherwise, is my own work and that all references have been properly made. This dissertation has not been submitted to any other university in full or partial fulfilment of the academic requirements of any other degree or qualifications.

Signed at Durban on the 28th day of January 2019.

Signature: 

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ABSTRACT

Herbalife is an international direct selling company involved in the production, promotion and sales of a variety of nutritional products including those designed to assist with weight management and personal care. The company has frequently come under legal scrutiny, most recently in the United States of America where it was the subject of a Federal Trade Commission (FTC) investigation. Herbalife shareholders alleged that Herbalife International of America, Inc., Herbalife International, Inc., and Herbalife, Ltd. (the Herbalife companies) were operating like an illegal pyramid scheme rather than like a legitimate multi-level marketing (MLM) company which it purported to be.

Pyramid schemes can take different forms and sizes but all share certain common characteristics. The main feature of these schemes is that distributors are primarily compensated for the introduction of new recruits rather than for actual retail sales. The problem with this is that there are a finite number of human beings to recruit and such schemes cannot sustain themselves. It is for this reason that pyramid schemes are mathematically improbable hence unlawful.

The FTC investigation concluded that Herbalife was not a pyramid scheme but required that the company make certain changes to its business model and prove, going forward, that its business model is sustainable. This dissertation examines whether Herbalife's business model amounts to a prohibited scheme under the Consumer Protection Act 68 of 2008. This issue will be analysed particularly through the lens of section 43 of the Act. To help better understand the legal stance on pyramid schemes, pyramid schemes will be viewed in comparison with legitimate MLM firms such as Avon Products Inc. and Tupperware Brands Corporation. In addition, the Herbalife business model will also be viewed in light of other sections of the CPA which proscribes certain conduct.

CHAPTER 1

INTRODUCTION

1.1 Background

Herbalife is an international direct-selling company that sells a range of products including those dealing with weight management and nutrition. The company sells products to its members who buy the product for either personal use or for resale to other members whom they have recruited. Herbalife also sponsors many athletes, professional teams and leagues as well as a few National Olympic Committees, the likes of which include Portuguese soccer player Cristiano Ronaldo and soccer team Los Angeles Galaxy.¹

Herbalife has frequently come under legal scrutiny. Many people believe that Herbalife is a scam because it operates in a pyramid-like manner. However, others are of the view that Herbalife is a legitimate network marketing company. The manner in which Herbalife operates is what led to the allegations in the United States of America that Herbalife is an illegal pyramid scheme. However, following an investigation by the Federal Trade Commission (FTC), it was concluded that the company was not in fact an illegal pyramid scheme.² The Commission did, however, require Herbalife to make changes to its business practices and called on Herbalife to prove, going forward, that its business model is sustainable.³ Despite questions about Herbalife and its business model, no South African authority such as the Department of Trade and Industry (DTI) or the National Consumer Commission (NCC)⁴ has investigated these allegations.

¹ Kaki 'Does celebrity endorsements have the potential to transform a brand?' 1 August 2016 available at <https://mpk732t22016clusterb.wordpress.com/2016/08/01/does-celebrity-endorsements-have-the-potential-to-transform-a-brand/> (accessed on 17 May 2018). Information about Herbalife celebrity endorsements can also be found on the Herbalife website available at <http://company.herbalife.com/sponsorships/> (accessed on 17 May 2018).

² Cullen 'Herbalife soars after dodging pyramid scheme tag in FTC settlement' 15 July 2016 available at <https://finance.yahoo.com/news/herbalife-soars-dodging-pyramid-scheme-143038125.html?guccounter=1> (accessed on 19 April 2018).

³ Ibid.

⁴ The NCC is an organ of state assigned with the task of ensuring enforcement of the CPA. The NCC and its role will be further discussed in Chapter 3.

In 2003, Woker wrote that pyramid schemes were on the rise in South Africa with more people falling victim to these schemes every day.⁵ She also pointed out that South Africa's past, together with poverty and a high unemployment rate, creates a 'fertile breeding ground for opportunists'.⁶ In 2009, the Consumer Protection Act 68 of 2008 (hereinafter referred to as the CPA) was passed as law.⁷ The Act deals specifically with pyramid and other unlawful schemes yet it seems that South Africa continues to provide a fertile ground for those who wish to promote unlawful schemes. In 2016, the South African Reserve Bank (SARB) investigated 27 money scams. The Bank Supervision Department's annual report revealed that 19 of these schemes had been carried over from previous years whilst the other eight were new.⁸

The old adage 'if it sounds too good to be true it probably is' probably best describes pyramid schemes. Promoters entice people to join the scheme with false promises of making a lot of money. Consumers gravitate toward these schemes because of greed or gullibility. Hoexter JA said the following with regard to pyramid schemes:

'History. . . teaches us that in the human breast greed and gullibility are often partners. It is on these twin weaknesses that all confidence-tricksters trade; and not a few flourish'.⁹

These schemes appear on the face of it to be more lucrative investment opportunities as opposed to conventional methods of investment.¹⁰ Consumers are attracted by the possibility of obtaining instant wealth and acquiring possessions such as lavish cars and houses, all while exercising minimal effort.¹¹

Pyramid schemes were recognised as a problem in South Africa long before the inception of the CPA. In 1980, conditions were imposed on the operation of these and other similar schemes by the DTI.¹² This was followed by regulations adopted under

⁵ Woker 'If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds' (2003) 15 *SA Mercantile Law Journal* 237.

⁶ Ibid 238.

⁷ Melville *The Consumer Protection Act made easy* 2 ed (2011) 1.

⁸ Omarjee 'SARB took on 27 scams in 2016 – report' 26 May 2017 available at <https://www.fin24.com/Companies/Financial-Services/sarb-took-on-27-scams-in-2016-report-20170526> (accessed on 2 May 2018).

⁹ *Commissioner for Inland Revenue v Insolvent Estate Botha t/a 'Trio Kulture'* 1990 (2) SA 548 (A) at 554D – E.

¹⁰ Woker 'If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds' (2003) 15 *SA Mercantile Law Journal* 237.

¹¹ GN 1134 of GG 20169 9/6/1999 4.

¹² Reg 469 of GG 6880 14/3/1980.

the Harmful Business Practices Act 71 of 1988 (this Act was later renamed the Consumer Affairs (Unfair Business Practices Act)).

The Harmful Business Practices Act was established to enable the Harmful Business Practices Committee (subsequently renamed the Consumer Affairs Committee) ('the Committee') to investigate harmful business practices. The Committee, following an investigation, could then make recommendations to the Minister of Trade and Industry.¹³ In some instances, the Minister would issue regulations which regulated the business practices to ensure that they did not harm consumers and in other instances, the Minister closed the business down completely, declaring it to be a harmful business practice.¹⁴

At first the Committee investigated individual businesses which were subsequently declared to be harmful pyramid and other similar type schemes.¹⁵ Two businesses that were investigated by the Committee were Rainbow Business Club and Newport Business Club (Pty) Ltd.¹⁶ The Committee then conducted a general investigation into pyramid schemes, money multiplication schemes and chain letters which identified the hallmarks of such unlawful schemes.¹⁷ The Minister then issued regulations declaring that pyramid schemes, money multiplication schemes and chain letters were harmful business practices and that it was a criminal offence to participate in such a scheme.¹⁸

Those regulations were then incorporated into the CPA namely in section 43(2)(b) and section 43(4)(a).

1.2 Statement of purpose

The purpose of this dissertation is to critically examine how Herbalife operates in South Africa and to determine whether or not Herbalife is contravening South African legislation on pyramid schemes.

¹³ Woker 'Why the need for consumer protection legislation? A look at some of the reasons behind the promulgation of the National Credit Act and the Consumer Protection Act' (2010) 31(2) *Obiter* 220.

¹⁴ *Ibid* 219-220.

¹⁵ Woker 'If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds' 2003 15 *SA Mercantile Law Journal* 240.

¹⁶ GN 1134 of 2016/9/6/1999 5.

¹⁷ Woker 'If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds' (2003) 15 *SA Mercantile Law Journal* 240.

¹⁸ *Ibid*.

In order to fulfil the purpose, section 43 of the CPA will be analysed and pyramid schemes will be compared and contrasted with legitimate multi-level marketing programmes such as Avon Products Inc. and Tupperware Brands Corporation.

1.3 Rationale

Although the CPA came into operation eight years ago, in 2011, many people are still unaware that participating in pyramid schemes is illegal.¹⁹ Pyramid schemes continue to operate in South Africa.²⁰ These schemes take on many forms and sizes and each one can differ from the next.²¹ However, the common thread among pyramid schemes is that a few participants benefit at the expense of the majority of the participants. Those at the bottom of the pyramid often find themselves losing their investments. Promoters usually disappear without a trace, leaving participants with no means of recourse and no way to recoup their investment.²²

Herbalife is a successful business that operates throughout the world. The company operates in over 90 countries across the Americas, Europe, the Middle East, Africa and Asia Pacific.²³ It began in South Africa in 1995 where it continues to operate.²⁴ However, Herbalife is often criticised for being a pyramid scheme and has been investigated in a number of different countries, most notably the United States of America where it has been the subject of an FTC investigation.²⁵ Even in South Africa there have been allegations that Herbalife is an unlawful pyramid scheme.

¹⁹ *Joroy 4440 CC v Potgieter* 2016 (3) SA 465 (FB).

²⁰ Arde, 'Pyramid scams thriving in SA' 6 February 2016 available at <https://www.iol.co.za/personal-finance/pyramid-scams-thriving-in-sa-1980769> (accessed on 21 February 2018).

²¹ Valentine 'International Monetary Funds Seminar on Current Legal Issues Affecting Central Banks' 13 May 1998 available at <https://www.ftc.gov/public-statements/1998/05/pyramid-schemes> (accessed on 9 July 2018).

²² Paterson 'Pyramid schemes and other related practices: What you need to know' available at <https://dommisseattorneys.co.za/blog/pyramid-schemes-and-other-related-practices-what-you-need-to-know/> (accessed on 31 August 2018).

²³ Information regarding Herbalife is available on its website <http://www.herbalife.com/global> (accessed on 12th April 2018).

²⁴ Majola and Dini 'All that glitters: an exploration of the Pyramid Scheme and Ponzi Scheme phenomena and what the law is doing to protect consumers' 15 July 2015 available at <https://www.lexology.com/library/detail.aspx?g=c62b13a4-d053-48d5-bef2-3b1ac7a85351> (accessed on 21 February 2018).

²⁵ Partnoy 'Is Herbalife a Pyramid Scheme?' June 2014, available at <https://www.theatlantic.com/magazine/archive/2014/06/wall-streets-6-billion-mystery/361624/> (accessed on 18th April 2018).

Nevertheless, South Africans are still involved in Herbalife and, should it be found that the company is in fact a pyramid scheme, its members could lose their investment.

The reason behind this dissertation is to determine whether or not Herbalife is a pyramid scheme under South African law thereby educating people who wish to join the company.

1.4. Research questions

This study intends to answer the following questions:

1. What is a pyramid scheme and how can such schemes be identified?
2. What is multi-level marketing and to what extent does legitimate multi-level marketing differ from a pyramid scheme?
3. What is the South African law on pyramid schemes?
4. What is Herbalife and how does it operate?
5. How does the United States of America view Herbalife?

1.5. Methodology

This research paper is solely desktop-based. Information is drawn mainly from textbooks, journal articles, government publications and internet sources. The CPA and other legislation will also be considered.

1.6. Structure of the dissertation

Chapter 1 provides an introduction to this mini-dissertation setting out the background to the topic followed by the statement of purpose and rationale. The research questions which will be answered in this dissertation are then listed and the research methodology which will be adopted is discussed. The chapter concludes with the structure of this dissertation.

Chapter 2 discusses the concepts of pyramid scheme and multi-level marketing and distinguishes between the two. This chapter will focus, in particular, on the hallmarks of a pyramid scheme.

The focus of Chapter 3 is on the law governing pyramid schemes in South Africa. A brief history of the law will precede a critical examination of section 43 of the CPA. This chapter also includes an analysis of other relevant sections of the CPA. The chapter concludes with a brief discussion of the common law concept of fraud.

Chapter 4 discusses Herbalife's business model. The chapter will analyse the allegations that Herbalife operates as a pyramid scheme and will consider the investigation that took place in the United States, following which Herbalife was found not to be a pyramid scheme but it was required to make certain changes and to give certain assurances. A synopsis of the current allegations against Herbalife, in the United States, is also contained in this chapter.

Chapter 5 looks at and examines Herbalife from a South African legal perspective.

Chapter 6 concludes the study and contains recommendations for Herbalife.

CHAPTER 2

PYRAMID SCHEMES AND MULTI-LEVEL MARKETING

2.1 Introduction

During the 1990s, the number of pyramid schemes rapidly increased,²⁶ as did the international growth of multi-level marketing.²⁷ It is sometimes difficult to distinguish between an illegal pyramid scheme and a legitimate multi-level marketing programme.²⁸ This chapter will explain the term pyramid scheme, differentiate between promotional and product-based schemes, discuss how pyramid schemes can be identified and consider the problems associated with these schemes. This discussion will be followed by an analysis of what constitutes multi-level marketing, the 'legal cousin' of pyramid schemes.²⁹ To better illustrate the concept of multi-level marketing, legitimate companies such as Avon Products Inc (Avon) and Tupperware Brands Corporation (Tupperware) will be considered. The chapter concludes with a test to help determine whether or not a particular scheme is a pyramid scheme.

2.2 Pyramid schemes

2.2.1 Hallmarks of a pyramid scheme

Pyramid schemes can be diverse in nature but all pyramid schemes share common characteristics. These hallmarks can assist in identifying whether or not an investment opportunity is a legitimate business opportunity or a pyramid scheme. Where a pyramid scheme is involved, there are either no products or services for sale or those that are being sold have little or no value for the consumer.³⁰ Promoters of the scheme

²⁶ Ramsay *Consumer Law and Policy Text and Materials on Regulating Consumer Markets* 2 ed 2007 327.

²⁷ Vander Nat and Keep 'Marketing Fraud: An Approach for Differentiating Multilevel marketing from Pyramid Schemes' (2002) 21(1) *Journal of Public Policy & Marketing* 139.

²⁸ Ramsay *Consumer Law and Policy Text and Materials on Regulating Consumer Markets* 2 ed 2007 327.

²⁹ Krige 'Fields of Dreams, Fields of Schemes: Ponzi Finance and Multi-level Marketing in South Africa' (2012) 82(1) *Africa* 70.

³⁰ Paterson 'Pyramid schemes and other related practices: What you need to know' available at <https://dommisseattorneys.co.za/blog/pyramid-schemes-and-other-related-practices-what-you-need-to-know/> (accessed on 31 August 2018).

also engage in false advertising regarding how valuable the product is,³¹ for example, they purport to sell miracle creams.³² Products are usually overpriced and incidental to the business opportunity.³³ Distributors are encouraged to purchase large quantities of goods up-front and there is often no repurchase scheme for unsold goods.³⁴

Another tell-tale sign of a pyramid scheme is a complex commission structure. A complex commission structure is cause for concern when products or services are not sold to people outside the organisation.³⁵ Schemes are also promoted as a get-rich-quick investment with promoters falsifying or exaggerating financial figures and potential earnings.³⁶

Pyramid schemes are composed of various levels comprising a pyramid structure and those at the bottom of the pyramid benefit only after those at the top.³⁷ Furthermore, (and possibly the main feature of a pyramid scheme) income is derived principally from the recruitment of new investors into the scheme with actual retail sales contributing minimally to a distributor's earnings.³⁸ This is sometimes known as a head-hunting fee.³⁹

Upon joining the scheme, members are required to make an investment.⁴⁰ This is referred to as a joining fee.⁴¹ In order to recoup one's own investment, a participant in a scheme needs to canvass new members who need to canvass new members and

³¹ Ibid.

³² Majola and Dini 'All that glitters: an exploration of the Pyramid Scheme and Ponzi Scheme phenomena and what the law is doing to protect consumers' 15 July 2015 available at <https://www.lexology.com/library/detail.aspx?g=c62b13a4-d053-48d5-bef2-3b1ac7a85351> (accessed on 21 February 2018).

³³ This feature of a pyramid scheme is discussed on the Facts About Herbalife website available at <https://www.factsaboutheralife.com/the-facts/the-herbalife-pyramid-scheme/> (accessed on 8 November 2018).

³⁴ Clarke... et al *Successful Network Marketing A South African Guide* (1996) 63.

³⁵ This feature of a pyramid scheme is discussed on the Facts About Herbalife website available at <https://www.factsaboutheralife.com/the-facts/the-herbalife-compensation-plan/> (accessed on 8 November 2018).

³⁶ Clarke ... et al *Successful Network Marketing A South African Guide* (1996) 63.

³⁷ Paterson 'Pyramid schemes and other related practices: What you need to know' available at <https://dommisseattorneys.co.za/blog/pyramid-schemes-and-other-related-practices-what-you-need-to-know/> (accessed on 31 August 2018).

³⁸ Ibid.

³⁹ Clarke ... et al *Successful Network Marketing A South African Guide* (1996) 63.

⁴⁰ Nhlapo 'We're Still Falling For Ponzi And Pyramid Schemes' 9 March 2018 available at https://www.huffingtonpost.co.za/2018/03/09/were-still-falling-for-ponzi-and-pyramid-schemes_a_23381530/ (accessed on 31 August 2018).

⁴¹ Albaum and Peterson 'Multilevel (network) marketing: an objective view' *The Marketing Review* (2011) 11(4) 352.

so forth.⁴² The following very basic example illustrates how this works: the founder of a pyramid scheme recruits five members, each of whom have to pay R500 to join the scheme. They are then in turn required to recruit five other members each of whom pays R500. Provided they are able to recruit five members each, the first five recruits will each earn R2000 in profit.

Again, assuming that the initial five recruits each recruit five more people, those 25 new recruits need to each recruit five others in order to make R2000. Thus, there needs to be 125 new willing participants. Those at the subsequent level then need to sign up a further 725 people in order to generate a profit.⁴³ Thus, the number of participants required for each new level to make a profit increases as the levels increase.

Pyramid schemes are dependent on a constant inflow of new participants, a situation which is mathematically improbable because 'there is a finite number of human beings to recruit'.⁴⁴ The longer a scheme is in existence, the harder it is to find new members.⁴⁵ Inevitably, there will come a time when there is an insufficient number of new recruits and the scheme cannot sustain itself. The scheme will collapse 'when the inflow of funds no longer sustain[s] the outflow of extravagant returns to participants'.⁴⁶ Consequently, the majority of investors are financially at a loss and unable to recoup their investment.⁴⁷

In summary, pyramid schemes are fraudulent business ventures that mislead consumers as to the true nature of the scheme.⁴⁸ In promoting the scheme, the

⁴² Coughlan 'FAQs on MLM Companies' July 2012 available at http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf accessed on 22 May 2018.

⁴³ Majola and Dini 'All that glitters: an exploration of the Pyramid Scheme and Ponzi Scheme phenomena and what the law is doing to protect consumers' 15 July 2015 available at <https://www.lexology.com/library/detail.aspx?g=c62b13a4-d053-48d5-bef2-3b1ac7a85351> (accessed on 21 February 2018).

⁴⁴ Coughlan 'FAQs on MLM Companies' July 2012 available at http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf (accessed on 22 May 2018).

⁴⁵ GN 1134 of 2016 9/6/1999.

⁴⁶ *Fourie NO & Others v Edeling NO & Others* 2005 (4) All SA 393 (SCA).

⁴⁷ Valentine 'International Monetary Funds Seminar on Current Legal Issues Affecting Central Banks' 13 May 1998 available at <https://www.ftc.gov/public-statements/1998/05/pyramid-schemes> (accessed on 9 July 2018).

⁴⁸ Mabe 'Setting aside Transactions from Pyramid Schemes as Impeachable Dispositions under South African Insolvency Legislation' (2016) 19 *PER / PELJ* 6.

organisers misrepresent potential earnings to potential recruits.⁴⁹ Recruits are led to believe that financial success is attainable by participating in these schemes,⁵⁰ however, it is usually only those at the top of the pyramid, such as the initial organisers, who are enriched.⁵¹

2.2.2 Promotional pyramid schemes and product-based pyramid schemes

Pyramid schemes can be divided into two categories namely, promotional pyramid schemes and product-based pyramid schemes.⁵² Promotional pyramid schemes (also known as investment-based or naked pyramid schemes)⁵³ invite potential investors to join an organisation or club. Meetings are held during which investors are convinced to pay forward a sum of money to the promoter, money which can be recovered through recruiting more members.⁵⁴ Because compensation is based solely on recruitment, promotional pyramid schemes are described as wealth transfer schemes⁵⁵ and are generally regarded as illegal, fraudulent schemes.⁵⁶ The FTC also classified these schemes as an unfair and deceptive practice.⁵⁷ These were the original pyramid type schemes and it was because they were generally regarded as fraudulent (thus illegal) that promoters of such schemes started to evolve their schemes into schemes that sold products.⁵⁸

⁴⁹ Vander Nat and Keep 'Marketing Fraud: An Approach for Differentiating Multilevel marketing from Pyramid Schemes' (2002) 21(1) *Journal of Public Policy & Marketing* 141.

⁵⁰ Ibid.

⁵¹ Hagan *Crime Types and Criminals* 2010 177.

⁵² Woker 'If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds' (2003) 15 *SA Mercantile Law Journal* 240.

⁵³ Practical Law Commercial Transactions 'Legitimate Multi-Level Marketing Plans Versus Illegal Pyramid Schemes' 2018 Practical Law Practice Note w-011-5206 available on Thomson Reuters Westlaw (accessed on 13 July 2018).

⁵⁴ Woker 'If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds' (2003) 15 *SA Mercantile Law Journal* 240.

⁵⁵ Keep and Vander Nat 'Multilevel Marketing and Pyramid Schemes in the United States: An Historical Analysis' (2014) 6(4) *Journal of Historical Research in Marketing* (forthcoming) 6.

⁵⁶ Vander Nat and Keep 'Marketing Fraud: An Approach for Differentiating Multilevel marketing from Pyramid Schemes' (2002) 21(1) *Journal of Public Policy & Marketing* 140.

⁵⁷ Taylor 'The Case (for and) against Multi-level Marketing' Consumer Awareness Institute 2011 available at https://www.ftc.gov/sites/default/files/documents/public_comments/trade-regulation-rule-disclosure-requirements-and-prohibitions-concerning-business-opportunities-ftc.r511993-00017%C2%A0/00017-57317.pdf (accessed on 17 April 2018).

⁵⁸ Vander Nat and Keep 'Marketing Fraud: An Approach for Differentiating Multilevel marketing from Pyramid Schemes' (2002) 21(1) *Journal of Public Policy & Marketing* 140.

Product-based pyramid schemes involve the selling of a product or service.⁵⁹ However, sales are usually only made internally (to those within the organisation) or to new recruits.⁶⁰

These schemes are complex and exist in multiple forms. In addition to recruiting others, distributors may be required to pay fees and/or purchase products or services up front or compensation could be calculated based on recruitment, with actual retail sales mostly or completely excluded from the equation.⁶¹

The problem with product-based schemes is that they misrepresent to recruits and potential recruits the income that can be expected. As stated by Keep and Vander Nat, 'all [product-based schemes] claimed income levels well above what could realistically be achieved'.⁶² An additional problem is that distributors often end up with products they are unable to sell or return,⁶³ products which in most cases have little to no value.⁶⁴

The introduction of products in pyramid schemes makes it difficult to distinguish between an illegal pyramid scheme and a legitimate MLM programme. However, even in schemes where there is a product involved, the primary focus is still on recruitment. Investors join the scheme with the intention of generating a profit and not because they believe in the product being sold.⁶⁵ The product is of insignificant value to the consumer,⁶⁶ and is used to detract from the fact that the business venture is a pyramid scheme.⁶⁷

⁵⁹ Practical Law Commercial Transactions 'Legitimate Multi-Level Marketing Plans Versus Illegal Pyramid Schemes' 2018 Practical Law Practice Note w-011-5206 available on Thomson Reuters Westlaw (accessed on 13 July 2018).

⁶⁰ Valentine 'International Monetary Funds Seminar on Current Legal Issues Affecting Central Banks' 13 May 1998 available at <https://www.ftc.gov/public-statements/1998/05/pyramid-schemes> (accessed on 9 July 2018).

⁶¹ Keep and Vander Nat 'Multilevel Marketing and Pyramid Schemes in the United States: An Historical Analysis' (2014) 6(4) *Journal of Historical Research in Marketing* (forthcoming) 6-9.

⁶² Vander Nat and Keep 'Marketing Fraud: An Approach for Differentiating Multilevel marketing from Pyramid Schemes' (2002) 21(1) *Journal of Public Policy & Marketing* 140.

⁶³ *Ibid* 140-141.

⁶⁴ Woker 'Section 43' in Naude and Eiselen (eds) *Commentary on the Consumer Protection Act* (Original Service 2014) para 20.

⁶⁵ *Ibid*.

⁶⁶ *Ibid*.

⁶⁷ Valentine 'International Monetary Funds Seminar on Current Legal Issues Affecting Central Banks' 13 May 1998 available at <https://www.ftc.gov/public-statements/1998/05/pyramid-schemes> (accessed on 9 July 2018).

2.3 Multi-level marketing

2.3.1 What is multi-level marketing?

Multi-level marketing (MLM) is a legitimate form of direct selling,⁶⁸ or retail distribution,⁶⁹ which began in the 1940s.⁷⁰ It is also known as network marketing, relationships selling and multi-level direct selling.⁷¹ It is an alternative business model⁷² suitable for entrepreneurs who are financially ill-equipped to start their own business or join a franchise because in most cases they are joining an already established business.⁷³ Participants usually join MLM firms because of its associated benefits which include being able to work from home and work flexible hours whilst earning an income or supplementing their income.⁷⁴

MLM programmes are legal provided compensation is not derived primarily through recruitment. Furthermore, the firm must offer a tangible product or service to the public,⁷⁵ 'without requiring these consumers to pay anything extra or to join the MLM system'.⁷⁶ Most MLM firms offer a variety of products and/or services,⁷⁷ which, unlike pyramid schemes, have real value to purchasers.⁷⁸ Product distribution usually takes place face-to-face with registered independent distributors meeting customers in

⁶⁸ Woker 'Section 43' in Naude and Eiselen (eds) *Commentary on the Consumer Protection Act* (Original Service 2014) para 19.

⁶⁹ Coughlan 'FAQs on MLM Companies' July 2012 available at http://www.kellogg.northwestern.edu/faculty/coughlan/html/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf (accessed on 22 May 2018).

⁷⁰ Keep and Vander Nat 'Multilevel Marketing and Pyramid Schemes in the United States: An Historical Analysis' (2014) 6(4) *Journal of Historical Research in Marketing* (forthcoming) 14.

⁷¹ Deepalakshmi 'Distributors perception towards marketing of direct selling products with special reference to Herbalife' (2017) 2(4) *International Journal of Academic Research and Development* 361.

⁷² Keep and Vander Nat 'Multilevel Marketing and Pyramid Schemes in the United States: An Historical Analysis' (2014) 6(4) *Journal of Historical Research in Marketing* (forthcoming) 1.

⁷³ Coughlan 'FAQs on MLM Companies' July 2012 available at http://www.kellogg.northwestern.edu/faculty/coughlan/html/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf (accessed on 22 May 2018).

⁷⁴ Practical Law Commercial Transactions 'Legitimate Multi-Level Marketing Plans Versus Illegal Pyramid Schemes' 2018 Practical Law Practice Note w-011-5206 available on Thomson Reuters Westlaw (accessed on 13 July 2018).

⁷⁵ Krige 'Fields of Dreams, Fields of Schemes: Ponzi Finance and Multi-level Marketing in South Africa' (2012) 82(1) *Africa* 70.

⁷⁶ Valentine 'International Monetary Funds Seminar on Current Legal Issues Affecting Central Banks' 13 May 1998 available at <https://www.ftc.gov/public-statements/1998/05/pyramid-schemes> (accessed on 9 July 2018).

⁷⁷ Vander Nat and Keep 'Marketing Fraud: An Approach for Differentiating Multilevel marketing from Pyramid Schemes' (2002) 21(1) *Journal of Public Policy & Marketing* 139.

⁷⁸ Woker 'Section 43' in Naude and Eiselen (eds) *Commentary on the Consumer Protection Act* (Original Service 2014) para 21.

person.⁷⁹ Sales can be done door-to-door, on a party plan basis (product parties) or may even be concluded telephonically.⁸⁰ Different MLM programmes have different compensation plans,⁸¹ however, distributors are generally compensated for their own retail sales (the compensation value being the difference between retail price and cost price) as well as the sales concluded by members in their downline (that is, their direct and indirect recruits).⁸² A distributor's own sales includes products purchased for personal consumption, a concept known as internal consumption.⁸³ In addition, MLM marketers may sometimes receive commission for bringing in new recruits. This blurs the line between pyramid schemes and MLM firms but in the case of MLM, this commission is permitted in terms of the Direct Marketing Code of Conduct.⁸⁴

Distributors have a symbiotic relationship with their respective MLM companies.⁸⁵ One of the functions of an MLM firm is to provide a product or service that is then sold by its distributors.⁸⁶ The distributor may take on a dual role operating as both salesperson and sales manager.⁸⁷ Being a salesperson requires, *inter alia*, informing consumers about the products and/or services and enabling them to purchase these, should they so wish. The role of a sales manager, on the other hand, involves recruiting others wanting to join the firm, helping them register as distributors and training them in

⁷⁹ Vander Nat and Keep 'Marketing Fraud: An Approach for Differentiating Multilevel marketing from Pyramid Schemes' (2002) 21(1) *Journal of Public Policy & Marketing* 140. Registered independent distributors are also known as 'independent sales agents, representatives, members, participants, or independent business owners'. Practical Law Commercial Transactions 'Legitimate Multi-Level Marketing Plans Versus Illegal Pyramid Schemes' 2018 Practical Law Practice Note w-011-5206 available on Thomson Reuters Westlaw (accessed on 13 July 2018).

⁸⁰ Woker 'Section 43' in Naude and Eiselen (eds) *Commentary on the Consumer Protection Act* (Original Service 2014) para 19.

⁸¹ Vander Nat and Keep 'Marketing Fraud: An Approach for Differentiating Multilevel marketing from Pyramid Schemes' (2002) 21(1) *Journal of Public Policy & Marketing* 140.

⁸² Coughlan 'FAQs on MLM Companies' July 2012 available at http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf (accessed on 22 May 2018).

⁸³ Peterson and Albaum 'On the Ethicality of Internal Consumption in Multilevel Marketing' (2007) 27(4) *Journal of Personal Selling & Sales* 317.

⁸⁴ Woker 'If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds' (2003) 15 *SA Mercantile Law Journal* 243.

⁸⁵ Coughlan 'FAQs on MLM Companies' July 2012 available at http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf (accessed on 22 May 2018).

⁸⁶ *Ibid.*

⁸⁷ *Ibid.*

preparation for this role.⁸⁸ The success of an MLM firm is dependent on the contributions of the distributors and the firm itself.⁸⁹

The structure of MLM firms also differ and may comprise of a single level or multiple levels. The number of levels is, however, generally limited and not indefinite as is the case with pyramid schemes.⁹⁰

2.3.2 Examples of MLM firms

MLM firms vary considerably and span numerous different industries.⁹¹ Examples of well-known MLM firms include Avon and Tupperware.

Avon is an international company that operates in the cosmetic industry.⁹² The company offers a range of products such as makeup, perfumes and jewellery.⁹³ An Avon representative can earn commission in various ways.⁹⁴ Firstly, through face-to-face product sales. The amount of commission received depends on the order size but ranges from 20 to 40%. However, when a representative reaches a certain level (known as President's Club) they can earn up to 50%.⁹⁵ Secondly, commission can be earned via online sales (through a distributor's personal Avon website) or a combination of face-to-face and online sales. Lastly, commission can be earned through leadership. Leadership involves recruiting others (essentially forming a downline) who then begin their own Avon businesses.⁹⁶ There are different stages involved in the leadership programmes such as Advanced Unit Leader and Avon

⁸⁸ Ibid.

⁸⁹ Ibid.

⁹⁰ Albaum and Peterson 'Multilevel (network) marketing: an objective view' *The Marketing Review* (2011) 11(4) 351.

⁹¹ Practical Law Commercial Transactions 'Legitimate Multi-Level Marketing Plans Versus Illegal Pyramid Schemes' 2018 Practical Law Practice Note w-011-5206 available on Thomson Reuters Westlaw (accessed on 13 July 2018).

⁹² MarketLine 'Company Profile Avon Products Inc.' 13 October 2017 available on EBSCOhost web at <http://web.b.ebscohost.com.ukzn.idm.oclc.org/ehost/pdfviewer/pdfviewer?vid=3&sid=da821dbd-aa36-4370-b078-10addcd8cd0a%40pdc-v-sessmgr05> (accessed on 22 July 2018).

⁹³ Ibid.

⁹⁴ Information about the different ways an Avon representative can earn commission can be found on the Makeup Marketing Online website accessible on <http://www.makeupmarketingonline.com/can-you-make-money-selling-avon/> (accessed on 22 July 2018).

⁹⁵ Information on the different levels of commission in the Avon compensation structure can be found on the Makeup Marketing Online website available at <http://www.sellingbeautyonline.com/avon-commission-chart-2018/> (accessed on 22 July 2018).

⁹⁶ Information about the different ways an Avon representative can earn commission can be found on the Makeup Marketing Online website accessible on <http://www.makeupmarketingonline.com/can-you-make-money-selling-avon/> (accessed on 22 July 2018).

Executive Leader.⁹⁷ A representative's progress is determined by the number of recruits in his or her downline.⁹⁸

Tupperware is an internationally recognised brand that principally sells homeware, particularly kitchenware.⁹⁹ In addition, the company sells beauty products by brands such as Avroy Shlain and BeautiControl.¹⁰⁰ The various types of commission a Tupperware representative can earn are as follows: retail sales commission whereby distributors earn 25% commission on the products they have sold, bonuses on sales which are awarded to representatives who exceed a certain sales volume and lastly, commission on team performance which is awarded to managers and directors.¹⁰¹

There are different levels through which a Tupperware representative can transcend.¹⁰² The first is the level of a consultant who earns income from personal sales, second is a manager whose income is based on personal sales and total team sales, third is a team leader whose income is calculated on personal sales, total team sales as well as sales of the group and finally, at the apex is the level of distributor whose income is based on organisation sales.

As can be seen from the above two compensation plans, members in a legitimate MLM firm are *primarily* compensated through retail sales and not through the recruitment of new participants into the selling plan.

⁹⁷ Charissa 'Avon MLM Review-Avon MLM Explained' 12 October 2015 available at <http://www.marikinavalley.com/avon/avon-mlm-review-avon-mlm-explained/#avon%20compensation%20plan> (accessed on 22 July 2018).

⁹⁸ Ibid.

⁹⁹ MarketLine 'Company Profile Tupperware Brands Corporation' 13 July 2018 available on EBSCOhost web at <http://web.a.ebscohost.com.ukzn.idm.oclc.org/ehost/pdfviewer/pdfviewer?vid=4&sid=9ddf832a-303d-4d29-bf70-5553931a5812%40sessionmgr4007> (accessed on 31 August 2018).

¹⁰⁰ Ibid.

¹⁰¹ Information on Tupperware's compensation plan can be found on the MLM Tips and Advice website available at <https://www.mlmtipsandadvice.com.au/tupperware-compensation-plan/>.

¹⁰² Information of Tupperware's business model can be found on the Tupperware Brand's website available at <https://ir.tupperwarebrands.com/investor-story/business-model>.

2.3.3 Criticisms of MLM

The MLM model is not without criticism. There are those who oppose the idea claiming that all forms of MLM should be prohibited and not just pyramid schemes.¹⁰³ Critics argue that MLM programmes are unethical in that distributors pressurise friends and relatives to purchase the firms products, 'inflate earning claims during recruiting' and 'sell under the pretext of a party'.¹⁰⁴ However, despite these criticisms, MLM remains a legitimate means of direct selling.

2.4 Pyramid schemes versus MLM

Although all pyramid schemes are MLM companies, not all MLM companies are illegal pyramid schemes.¹⁰⁵ To help distinguish between the two, Albaum and Peterson have established a four-question test, the answers to which will determine whether or not an organisation is a pyramid scheme.¹⁰⁶ Firstly, one must identify the product or service that is being sold. Is it an actual product or service or merely 'the right to sell a product or service'?¹⁰⁷ Secondly, the joining fee needs to be considered. Is the amount that a participant is required to pay upon entering the organisation fair and reasonable? Is it proportionate to what the participant receives in return? Thirdly, is there inventory loading? Inventory loading is the practice whereby a company pressurises recruits to purchase products, often more products than which they are capable of selling.¹⁰⁸ Finally, does the MLM company have a buyback policy? That is, will the company buy back the unsold stock of a distributor who wishes to exit the company, thereby enabling the distributor to recoup some of their money?¹⁰⁹ If an actual product or service is being sold, the joining fee is reasonable as well as fair, the

¹⁰³ Practical Law Commercial Transactions 'Legitimate Multi-Level Marketing Plans Versus Illegal Pyramid Schemes' 2018 Practical Law Practice Note w-011-5206 available on Thomson Reuters Westlaw (accessed on 13 July 2018).

¹⁰⁴ Albaum and Peterson 'Multilevel (network) marketing: an objective view' *The Marketing Review* (2011) 11(4) 355.

¹⁰⁵ Walsh 'Multi-level Marketing Skirts Legal Lines' *Consumers' Research Magazine* (1999) 82(6) 13.

¹⁰⁶ Albaum and Peterson 'Multilevel (network) marketing: an objective view' *The Marketing Review* (2011) 11 (4) 352.

¹⁰⁷ Ibid.

¹⁰⁸ Valentine 'International Monetary Funds Seminar on Current Legal Issues Affecting Central Banks' 13 May 1998 available at <https://www.ftc.gov/public-statements/1998/05/pyramid-schemes> (accessed on 9 July 2018).

¹⁰⁹ Attri and Chaturvedi 'Study of Consumer Perceptions of the Products Sold Through Multilevel Marketing' *Management Research Journal* (2011) 5 (4) 102.

company does not force recruits to purchase products and has a buyback policy, then the company in question is not a pyramid scheme.¹¹⁰

2.5 Conclusion

Pyramid schemes and MLM are two distinct concepts but are often confused because of their similar hierarchical structure. The differences, however, lie in how they operate. The key feature of a pyramid scheme is that compensation is *primarily* derived through recruitment. Although MLM firms may sometimes compensate its members for recruiting others, this is not the *primary* source of compensation. MLM firms are more retail-focused with members predominantly generating an income from the sale of products and/or services offered by the firm. These products and services have real value to the consumer, unlike those which some pyramid schemes purport to sell. In addition, pyramid schemes often require its participants to pay unreasonable joining fees, pressurise them into buying products and do not cater for inventory buyback when a distributor wishes to leave the business.

MLM programmes provide a legitimate business opportunity for those wanting to earn an income whilst a pyramid scheme is merely 'a money-transfer scheme in which the foreseen losses of the vast majority become winnings for a small minority at the top of the recruitment structure.'¹¹¹ The continuous cycle of taking from Peter to pay Paul is unsustainable and mathematically improbable, given that there are a finite number of human beings to recruit.¹¹² Thus, whilst MLM companies are legitimate, pyramid schemes remain unlawful. The next chapter will deal with the South African law on pyramid schemes.

¹¹⁰ Albaum and Peterson 'Multilevel (network) marketing: an objective view' *The Marketing Review* (2011) 11(4) 352.

¹¹¹ Keep and Vander Nat 'Multilevel Marketing and Pyramid Schemes in the United States: An Historical Analysis' (2014) 6(4) *Journal of Historical Research in Marketing* (forthcoming) 10.

¹¹² Krige 'Fields of Dreams, Fields of Schemes: Ponzi Finance and Multi-level Marketing in South Africa' (2012) 82(1) *Africa* 70-71.

CHAPTER 3

PYRAMID SCHEMES AND THE LAW IN SOUTH AFRICA

3.1 Introduction

To help combat the problem of pyramid schemes discussed in Chapter 2, the South African government first introduced conditions regulating pyramid schemes.¹¹³ However, these regulations were regarded as being cumbersome and no reported decisions based on these regulations appear to exist.¹¹⁴ The legislature subsequently enacted legislation governing pyramid schemes. The two main pieces of legislation in this regard are the Harmful Business Practices Act (renamed the Consumer Affairs (Unfair Business Practices) Act) and the CPA.¹¹⁵ Both these Acts will be considered in this Chapter with the focus being on the CPA and section 43 in particular. Other relevant sections of the CPA will also be discussed, followed by a brief discussion of the common law position on fraud.

3.2 The Harmful Business Practices Act /The Consumer Affairs (Unfair Business Practices Act)

The purpose of this Act was to prohibit or control certain business practices.¹¹⁶ The Act was first introduced in 1988 and was then amended significantly in 1999. Before the amendments, the Act dealt with harmful business practices, but the Amendment Act widened the scope of the Act by introducing the concept of an unfair business practice. Hence, it was no longer necessary to show that a particular business practice was harmful, it was only necessary to show that the business practice was unfair to

¹¹³ Woker 'If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds' (2003) 15 *SA Mercantile Law Journal* 238.

¹¹⁴ Ibid.

¹¹⁵ Other pieces of legislation regarding pyramid schemes include the Banks Act 94 of 1990 and the Financial Advisory and Intermediary Services Act (FAIS) 37 of 2002. These pieces of legislation relate to pyramid schemes because the Banks Act regulates the taking of money from the general public and the FAIS Act regulates the giving of financial advice. A discussion of these aspects of pyramid schemes is beyond the scope of this mini-dissertation therefore, this dissertation will only deal with the Harmful Business Practices Act (Consumer Affairs (Unfair Business Practices) Act)) and the CPA.

¹¹⁶ Department of Trade and Industry 'Presentation on Consumer Protection' available at media.withtank.com/6adcc510b8.ppt (accessed on 16 August 2018).

consumers. Section 1 of the Amendment Act defines an unfair business practice (previously termed a harmful business practice)¹¹⁷ as

‘any business practice which, directly or indirectly, has or is likely to have the effect of –

- (a) harming the relations between businesses and consumers;
- (b) unreasonably prejudicing any consumer;
- (c) deceiving any consumer; or
- (d) unfairly affecting any consumer’.

To help fulfil its purpose, the Act established the Business Practices Committee (which under the Amendment Act was renamed the Consumer Affairs Committee (CAFCOM)).

The Consumer Affairs (Unfair Business Practices) Act was a piece of enabling legislation conferring certain powers upon CAFCOM. This included powers to conduct investigations.¹¹⁸ The National Office of Consumer Protection (OCP) acted on behalf of CAFCOM and was empowered to conduct investigations (both formal and informal) into alleged unfair business practices.¹¹⁹ Investigators required CAFCOM’s approval in order to conduct a section 4 (informal) or section 8 (formal) investigation.¹²⁰

Section 4(1)(c) of the Act provided for preliminary investigations. These investigations were informal and the details were not revealed publicly.¹²¹ These investigations were conducted when it was believed that there was a harmful business practice or there was a possibility that one could arise.¹²² The purpose of such investigation was to determine how the business in question operated,¹²³ and to establish whether there was a need for a section 8(1)(a) investigation to be concluded.¹²⁴ If the results of the investigation confirmed the existence or potential existence of an unfair business

¹¹⁷ *Janse van Rensburg and Another v Minister of Trade and Industry and Another* (CCT13/99) [2000] ZACC 18 at paragraph 9.

¹¹⁸ GN 2967 of GG 27125, 20/12/2004, 9.

¹¹⁹ Department of Trade and Industry ‘Presentation on Consumer Protection’ available at media.withtank.com/6adcc510b8.ppt (accessed on 16 August 2018).

¹²⁰ Ibid.

¹²¹ GN 2967 of GG 27125, 20/12/2004, 9.

¹²² GN 1134 of 20169 9/6/1999 4-5.

¹²³ GN 2967 of GG 27125, 20/12/2004, 9.

¹²⁴ GN 1134 of 20169 9/6/1999, 5.

practice, the OCP would convey this to CAFCOM.¹²⁵ As per section 9 of the Act, CAFCOM had the option of negotiating with any person or entity in order to try and reach an arrangement wherein the offending party agreed to stop engaging in the unfair conduct. If, however, CAFCOM's attempts at negotiation were unsuccessful, a section 8(1)(a) investigation could ensue.¹²⁶ A section 4(1)(c) investigation was not, however, mandatory. If *prima facie* evidence suggested that an unfair business practice was being conducted, the Committee could forgo the section 4(1)(c) investigation and immediately pursue a section 8(1)(a) investigation.¹²⁷

Unlike section 4(1)(c) investigations, section 8(1)(a) investigations were formal and notice thereof had to be published in the *Government Gazette*.¹²⁸ Section 8(1)(a) investigations were also known as particular investigations because the allegedly unfair business practices of particular entities, or unfair business practices which could arise in future,¹²⁹ were the subject of the investigation.¹³⁰ Section 8(1)(b) made provision for formal investigations that were more general in nature. In terms of this section, 'any business practice being applied by persons in general for the purposes of creating or maintaining a harmful business practice' could be investigated.¹³¹

These investigations were conducted either because the Committee took the initiative, upon receipt of a complaint by the public, or if the Committee received an instruction from the Minister of Trade and Industry because the Minister believed there was a need to conduct such an investigation.¹³²

A key difference between both the section 8 investigations is that orders made in respect of section 8(1)(a) investigations applied only to those whose business practices had been investigated while Ministerial orders made in response to section

¹²⁵ Department of Trade and Industry 'Consumer Affairs Committee Annual Report 2008/09' available at https://www.gov.za/sites/default/files/DTI_cafcom_annual%20report_11022010.pdf (accessed on 15 November 2018).

¹²⁶ Ibid.

¹²⁷ GN 188 of GG 34174, 31/03/2011, 7

¹²⁸ Department of Trade and Industry 'Consumer Affairs Committee Annual Report 2008/09' available at https://www.gov.za/sites/default/files/DTI_cafcom_annual%20report_11022010.pdf (accessed on 15 November 2018).

¹²⁹ GN 1134 of 20169 9/6/1999 4.

¹³⁰ Department of Trade and Industry 'Consumer Affairs Committee Annual Report 2008/09' available at https://www.gov.za/sites/default/files/DTI_cafcom_annual%20report_11022010.pdf (accessed on 15 November 2018).

¹³¹ GN 1134 of 20169 9/6/1999 4.

¹³² Van Eeden *A Guide to the Consumer Protection Act* (2009) 103-104.

8(1)(b) investigations applied to all those who were guilty of engaging in the particular practice that was investigated.¹³³

A host of general and specific investigations were conducted over a number of years.¹³⁴ Ultimately, the Committee concluded that there were three main types of schemes which had the potential to cause harm to consumers: pyramid promotional schemes, money revolving schemes and chain letters.¹³⁵ These schemes were declared to be harmful business practices by the Minister.¹³⁶ Both the act of establishing and participating in a pyramid scheme was prohibited.¹³⁷ If compensation from a scheme was not derived from the services the scheme offered or the products it sold, this was contrary to the Consumer Affairs (Unfair Business Practices) Act. Any person who was convicted of promoting or participating in such a scheme could be subject to a penalty not exceeding R200 000 and/or imprisonment for no longer than two years.¹³⁸

CAFCOM presented reports to the Minister following which the Minister could issue a notice in the *Government Gazette* suspending the practice pending the finalisation of the investigation.¹³⁹ If the Committee found that a practice was unfair, it made recommendations to the Minister who had various powers under section 12 of the Act. The Minister, after consideration of those recommendations, could elect to either accept or reject the recommendations.¹⁴⁰ If the Minister chose to accept the recommendations, an order was published in the *Government Gazette*.¹⁴¹ The Minister could declare a practice unlawful if it was unfair or contrary to the interest of the public.¹⁴² Furthermore, the Minister could direct any person to refrain from

¹³³ Department of Trade and Industry 'Consumer Affairs Committee Annual Report 2008/09' available at https://www.gov.za/sites/default/files/DTI_cafcom_annual%20report_11022010.pdf (accessed on 15 November 2018).

¹³⁴ For an example of a specific investigation see the investigation into the business practices of Zhauns Group of Companies in GN 188 of GG 34174, 31/03/2011. For an example of a general investigation see GN 469 of GG 28691, 30/03/2006.

¹³⁵ Woker 'If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds' (2003) 15 *SA Mercantile Law Journal* 240.

¹³⁶ Ibid.

¹³⁷ Department of Trade and Industry 'Presentation on Consumer Protection' available at media.withtank.com/6adcc510b8.ppt (accessed on 16 August 2018).

¹³⁸ Ibid.

¹³⁹ Ibid.

¹⁴⁰ Woker 'Why the need for consumer protection legislation? A look at some of the reasons behind the promulgation of the National Credit Act and the Consumer Protection Act' (2010) 31(2) *Obiter* 219.

¹⁴¹ Ibid.

¹⁴² Department of Trade and Industry 'Presentation on Consumer Protection' available at media.withtank.com/6adcc510b8.ppt (accessed on 16 August 2018).

perpetuating the practice directly or indirectly.¹⁴³ The Minister's power to order that an unfair business practice be stopped could, however, only be exercised after a section 8(1)(a) investigation and not after a preliminary investigation.¹⁴⁴ Decisions made by the Minister could be appealed by those affected.¹⁴⁵

As can be seen from the above discussion, CAFCOM's power was limited to just investigation and recommendations. CAFCOM itself could not order any redress for consumers who had been harmed by any business practices. If there was a breach of the Minister's orders, the matter had to be referred to the South African Police Service (SAPS) and the National Prosecuting Authority (NPA).¹⁴⁶ However, consumer issues were often neglected by these authorities as there were (and still are) more pressing criminal issues that warranted the attention of these enforcement agencies.¹⁴⁷

The Consumer Affairs (Unfair Business Practices) Act was the forerunner to the CPA.¹⁴⁸ Although the CPA repealed and replaced this Act,¹⁴⁹ it has influenced the contents of the CPA.¹⁵⁰ The discussion above therefore provides a useful context to section 43 of the CPA which now governs pyramid schemes.

¹⁴³ This includes 'advertising, becoming a party to arrangements, deriving interest or income etc.' Ibid.

¹⁴⁴ GN 2967 of GG 27125, 20/12/2004, 9.

¹⁴⁵ Department of Trade and Industry 'Presentation on Consumer Protection' available at media.withtank.com/6adcc510b8.ppt (accessed on 16 August 2018).

¹⁴⁶ Woker 'Why the need for consumer protection legislation? A look at some of the reasons behind the promulgation of the National Credit Act and the Consumer Protection Act' (2010) 31(2) *Obiter* 220.

¹⁴⁷ Ibid.

¹⁴⁸ Van Eeden *A Guide to the Consumer Protection Act* (2009) 103.

¹⁴⁹ *Imperial Group (Pty) Ltd t/a Auto Niche Bloemfontein v MEC: Economic Development, Environmental Affairs and Tourism Free State Government and Others* (A169/2014) [2016] ZAFSHC 105 at paragraph 28.

¹⁵⁰ '70% of the contents of the [Consumer Protection] Act are not new and derives from the repeal, consolidation and re-enactment of useful provisions in existing legislation'. This includes the Consumer Affairs (Unfair Business Practices) Act. Department of Trade and Industry 'Consumer Protection Act 68 of 2008' available at <https://www.insurancegateway.co.za/download/1310> (accessed on 27 August 2018).

3.3 The CPA

3.3.1 Background

The CPA was signed into law on 24 April 2009,¹⁵¹ and came into effect on 31 March 2011.¹⁵² The CPA is an attempt to consolidate South African consumer law,¹⁵³ and is regarded as ‘a single comprehensive legal framework for consumer protection’.¹⁵⁴ It is a step toward bringing South African legislation in line with international consumer rights.¹⁵⁵ The purposes of the CPA include protecting consumers from ‘deceptive, misleading, unfair or fraudulent conduct’,¹⁵⁶ promoting fair business practices¹⁵⁷ and prohibiting ‘certain unfair marketing and business practices’.¹⁵⁸

Chapter 2 contains eight fundamental rights which consumers have. Part F of Chapter 2 deals with a consumer’s right to fair and honest dealing. Section 43 (which covers pyramid and related schemes) falls under this part.

3.3.2 The CPA and pyramid schemes

The first important point to note about section 43 is that the schemes listed in section 43 are prohibited, not regulated.¹⁵⁹ In other words, there are no prescribed requirements which, if complied with, will render the schemes lawful.

Section 43(2)(b) expressly prohibits pyramid schemes. The section reads as follows:

‘a person must not directly or indirectly promote, or knowingly join, enter or participate in –

...

(b) a pyramid scheme, as described in subsection (4)

...

¹⁵¹ Melville *The Consumer Protection Act made easy* 2 ed (2011) 1.

¹⁵² *Joroy 4440 CC v Potgieter* 2016 (3) SA 465 (FB).

¹⁵³ Melville *The Consumer Protection Act made easy* 2 ed (2011) 3.

¹⁵⁴ Havenga ... et al *General Principles of Commercial Law* 7 ed (2010) 483.

¹⁵⁵ Melville *The Consumer Protection Act made easy* 2 ed (2011) 1.

¹⁵⁶ Van Eeden *A Guide to the Consumer Protection Act* (2009) 102.

¹⁵⁷ Ibid.

¹⁵⁸ As mentioned at the outset of the CPA.

¹⁵⁹ Van Eeden *A Guide to the Consumer Protection Act* (2009) 140.

or cause any other person to do so’.

The words ‘must not’ indicate that it is mandatory that persons abstain from becoming involved in pyramid schemes. The prohibition relates to both the participation in and promotion of a scheme. The first part of section 43(2)(b) ‘a person must not directly or indirectly promote, or knowingly join, enter or participate in...’ and the last part ‘or cause any other person to do so’ is regarded as the ‘required degree of involvement’ whilst a pyramid scheme (listed in paragraph (b)) will be the ‘identified activity’.¹⁶⁰ Thus if a person has the required degree of involvement in relation to the identified activity (that is, if they promote, or knowingly join, enter or participate or cause another person to promote, knowingly join, enter or participate in a pyramid scheme) they will be guilty of engaging in prohibited conduct.

In terms of section 43(4) of the CPA,

‘an arrangement, agreement, practice or scheme is a pyramid scheme if—

(a) participants in the scheme receive compensation derived primarily from their respective recruitment of other persons as participants, rather than from the sale of any goods or services; or

(b) the emphasis in the promotion of the scheme indicates an arrangement or practice contemplated in paragraph (a).’

The CPA definition above is centred around the most notable hallmark of a pyramid scheme. That is, pyramid schemes are focussed on the recruitment of more participants in the scheme as opposed to retail sales.¹⁶¹

The terms ‘consideration’ and ‘participant’ used in relation to pyramid schemes are defined in section 43(1)(a) and (b) respectively.

The definition of consideration is the same as that contained in section 1 with a few exceptions.¹⁶² The term consideration excludes:

¹⁶⁰ Van Eeden and Barnard *Consumer Protection Law in South Africa* 2 ed (2017) 176.

¹⁶¹ Woker ‘Section 43’ in Naude and Eiselen (eds) *Commentary on the Consumer Protection Act* (Original Service 2014) para 15.

¹⁶² Under section 1 the term consideration is defined as ‘anything of value given and accepted in exchange for goods or services, including— (a) money, property, a cheque or other negotiable instrument, a token, a ticket, electronic credit, credit, debit or electronic chip or similar object; (b) labour, barter or other goods or services; (c) loyalty credit or award, coupon or other right to assert a claim; or (d) any other thing, undertaking, promise, agreement or assurance, irrespective of its apparent or

‘(i) the purchase of any goods at cost to be used in making sales, or not for resale;

(ii) the purchase of any goods in exchange for which the seller of those goods offers to repurchase the participant’s products under reasonable commercial terms; and

(iii) the participant’s time and effort in pursuit of sales or recruiting activities’.¹⁶³

A participant is ‘a person who is admitted to a scheme for consideration’.¹⁶⁴ Participation includes involvement as an organiser or promoter of a scheme, consumer involvement by way of joining the scheme as well as causing other persons to participate in the scheme.¹⁶⁵ In pyramid schemes, the participative role of those involved often changes. People usually join the scheme as recruits and then they themselves become recruiters.¹⁶⁶ Any form of participation in pyramid schemes is illegal and will constitute a breach of the CPA.¹⁶⁷

Other key terms employed in the definition of pyramid scheme are ‘goods’, ‘services’ and ‘promotion’.

The word ‘goods’ as defined in section 1 of the CPA includes:

‘(a) anything marketed for human consumption;

(b) any tangible object not otherwise contemplated in paragraph (a), including any medium on which anything is or may be written or encoded;

(c) any literature, music, photograph, motion picture, game, information, data, software, code or other intangible product written or encoded on any medium, or a licence to use any such intangible product;

intrinsic value, or whether it is transferred directly or indirectly, or involves only the supplier and consumer or other parties in addition to the supplier and consumer’.

¹⁶³ Section 43(1)(a) of the CPA.

¹⁶⁴ Section 43(1)(b) of the CPA.

¹⁶⁵ Van Eeden *A Guide to the Consumer Protection Act* (2009) 140-141.

¹⁶⁶ Ibid.

¹⁶⁷ Participation in a pyramid scheme may also contravene other legislation such as the Banks Act 94 of 1990 and the Financial Advisory and Intermediary Services Act 37 of 2002. Harban ‘Ponzi and pyramid schemes: Participation is illegal even if promoted by a lawyer’ *The Regulatory Debates* 7 ed March 2018 available at <http://www.cgso.org.za/wp-content/uploads/2018/04/Final-Regulatory-Debates-March-2018.pdf> (accessed on 6 August 2018).

(d) a legal interest in land or any other immovable property, other than an interest that falls within the definition of 'service' in this section; and

(e) gas, water and electricity'.¹⁶⁸

The definition of 'service' as contained in the Act can be summarised as

'work performed by a person for the direct or indirect benefit of another; education, information, advice or consultation, banking or similar financial services,¹⁶⁹ transportation of goods or an individual; provision of accommodation, entertainment or access to entertainment, access to electronic communication infrastructure, access or a right of access to an event, premises, activity or facility or access to or use of property in terms of a rental. Service also includes the right of occupancy of, or power or privilege over, land or immovable property, and the rights of a franchisee in terms of a franchise agreement provided for in the Act'.¹⁷⁰

The word 'promote' means to—

'(a) advertise, display or offer to supply any goods or services in the ordinary course of business, to all or part of the public for consideration;

(b) make any representation in the ordinary course of business that could reasonably be inferred as expressing a willingness to supply any goods or services for consideration; or

(c) engage in any other conduct in the ordinary course of business that may reasonably be construed to be an inducement or attempted inducement to a person to engage in a transaction'.

It is presumed that when interpreting the meaning of the word 'advertise' as contained in paragraph (a) of the definition of 'promote', courts will look to the definition of

¹⁶⁸ The term 'goods' encompasses a variety of items. Under the definition, 'bread, compact discs (CDs), electronic appliances and books' can be classified as goods. Havenga ... et al *General Principles of Commercial Law* 7 ed (2010) 486.

¹⁶⁹ Excluded from the ambit of the definition of service are services or advice dealt with under the Financial Advisory and Intermediary Services Act 37 of 2002 or services covered under the Long-term Insurance Act 52 of 1998 or the Short-term Insurance Act 53 of 1998. The CPA is, however, applicable to the marketing of financial services. Ibid.

¹⁷⁰ The term service is not confined to the activities listed above. Havenga ... et al *General Principles of Commercial Law* 7 ed (2010) 486.

advertisement provided in section 1 of the Act.¹⁷¹ The use of the verb 'supply' in paragraphs (a) and (b) when used 'in relation to goods, includes sell, rent, exchange and hire in the ordinary course of business for consideration'¹⁷² and when used 'in relation to services, means to sell the services, or to perform or cause them to be performed or provided, or to grant access to any premises, event, activity or facility in the ordinary course of business for consideration'.¹⁷³

To promote a pyramid scheme is unlawful. Thus, if someone, in the ordinary course of business, advertises, displays, offers to supply or whose conduct indicates a willingness to supply, goods or services, for consideration, or induces or attempts to induce others to engage in the scheme, they will be guilty of unlawful conduct on the basis of promoting a prohibited scheme.

In addition to the schemes expressly classified in section 43 as being prohibited, section 43(2)(d) read with section 43(6) empowers the Minister of Trade and Industry to declare any arrangement, agreement, practice or scheme as prohibited if the purpose or effect of such scheme is similar to a scheme mentioned in section 43(2)(a)-(c), for example, a pyramid scheme.¹⁷⁴ Participating in a scheme declared prohibited by the Minister is also unlawful.

3.3.3 Other relevant provisions

In addition to section 43, the CPA contains numerous other provisions prohibiting unfair marketing and business practices. The CPA also contains sections which aim to fulfil its goal of protecting consumers from 'deceptive, misleading, unfair or fraudulent conduct'¹⁷⁵ and to safeguard consumers against 'unconscionable, unfair,

¹⁷¹ Van Eeden and Barnard *Consumer Protection Law in South Africa* 2 ed (2017) 44. Advertisement is defined as 'any direct or indirect visual or oral communication transmitted by any medium, or any representation or reference written, inscribed, recorded, encoded upon or embedded within any medium, by means of which a person seeks to— (a) bring to the attention of all or part of the public— (i) the existence or identity of a supplier; or (ii) the existence, nature, availability, properties, advantages or uses of any goods or services that are available for supply, or the conditions on, or prices at, which any goods or services are available for supply; (b) promote the supply of any goods or services; or (c) promote any cause'.

¹⁷² Ibid.

¹⁷³ Ibid.

¹⁷⁴ The Minister must declare the scheme as prohibited by means of a regulation which is published in compliance with section 120 of the CPA. Ibid 176.

¹⁷⁵ Section 3(1)(d)(ii).

unreasonable, unjust or otherwise improper trade practices'.¹⁷⁶ Sections 29, 40, and 41 are of particular relevance to this dissertation as well as sections 48, 51, 52 and 69 (insofar as it relates to sections 29, 40 or 41).

Section 29 addresses the general standards for the marketing of goods and services. According to section 29,

‘a producer, importer, distributor, retailer or service provider must not market any goods or services—

(a) in a manner that is reasonably likely to imply a false or misleading representation concerning those goods or services, as contemplated in section 41; or

(b) in a manner that is misleading, fraudulent or deceptive in any way

...’.

Subsection (b) goes on to list examples of marketing which may constitute misleading, fraudulent or deceptive conduct. It is apparent from subsection (a) that that provision has to be read with section 41.

As a whole, section 41 deals with the regulation of false, misleading or deceptive representations.¹⁷⁷ Under section 51(1)(i), a supplier is prohibited from concluding a transaction or agreement if the ‘general purpose or effect [thereof] is to mislead or deceive the consumer’.¹⁷⁸

Section 41 reads as follows:

‘(1) In relation to the marketing of any goods or services, the supplier must not, by words or conduct—

(a) directly or indirectly express or imply a false, misleading or deceptive representation concerning a material fact to a consumer;

¹⁷⁶ Section 3(1)(d)(i).

¹⁷⁷ Stoop ‘The Consumer Protection Act 68 of 2008 and Procedural Fairness in Consumer Contracts’ (2015) 18(4) *PER/PELJ* 1100.

¹⁷⁸ This section echoes s4(5)(b) which states that ‘in any dealings with a consumer in the ordinary course of business, a person must not... engage in any conduct that is unconscionable, misleading or deceptive, or that is reasonably likely to mislead or deceive’.

(b) use exaggeration, innuendo or ambiguity as to a material fact, or fail to disclose a material fact if that failure amounts to a deception; or

(c) fail to correct an apparent misapprehension on the part of a consumer, amounting to a false, misleading or deceptive representation, or permit or require any other person to do so on behalf of the supplier.

(2) A person acting on behalf of a supplier of any goods or services must not—

...

(b) engage in any conduct that the supplier is prohibited from engaging in under subsection (1)'.

Subsection (3) provides a list of guidelines as to what can be regarded as a false, misleading or deceptive representation, however, this list is not exhaustive.¹⁷⁹

Section 41 is a codification of the common law and it places emphasis on procedural fairness in contracts. Section 41(1)(a)-(c) lists the factors which affect procedural fairness.¹⁸⁰

Section 41(2) indicates that it is not just the supplier who is prohibited from engaging in the conduct described in section 41(1). The prohibition also extends to any person acting on the supplier's behalf.¹⁸¹

Section 48 of the CPA deals with unfair, unreasonable or unjust contract terms. The relevant parts of that section are:

'(1) A supplier must not—

...

(b) market any goods or services, or negotiate, enter into or administer a transaction or an agreement for the supply of any goods or services, in a manner that is unfair, unreasonable or unjust;

¹⁷⁹ Stoop 'The Consumer Protection Act 68 of 2008 and Procedural Fairness in Consumer Contracts' (2015) 18(4) *PER/PELJ* 1101.

¹⁸⁰ Hawthorne 'Public governance: Unpacking the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 358.

¹⁸¹ Stoop 'The Consumer Protection Act 68 of 2008 and Procedural Fairness in Consumer Contracts' (2015) 18(4) *PER/PELJ* 1100.

...

(2) Without limiting the generality of subsection (1), a transaction or agreement, a term or condition of a transaction or agreement, or a notice to which a term or condition is purportedly subject, is unfair, unreasonable or unjust if—

...

(c) the consumer relied upon a false, misleading or deceptive representation, as contemplated in section 41 or a statement of opinion provided by or on behalf of the supplier, to the detriment of the consumer;

...’.

Thus, if a consumer relies on a false, misleading or deceptive representation conveyed by the supplier or by someone acting on the supplier’s behalf and that reliance negatively impacts the consumer, such a term or contract will be unfair, unreasonable or unjust.

With regard to the latter part of section 48(2)(c), a statement of opinion does not have to be false, misleading or deceptive to amount to an unfair term or contract. If a statement concerning a material fact ultimately caused detriment to the consumer, it can be declared as being unfair.¹⁸²

Section 40 of the CPA covers unconscionable conduct. In terms of this section,

‘(1) A supplier or an agent of the supplier must not use physical force against a consumer, coercion, undue influence, pressure, duress or harassment, unfair tactics or any other similar conduct, in connection with any—

(a) marketing of any goods or services;

(b) supply of goods or services to a consumer;

(c) negotiation, conclusion, execution or enforcement of an agreement to supply any goods or services to a consumer;

...

¹⁸² Ibid 1101.

(2) In addition to any conduct contemplated in subsection (1), it is unconscionable for a supplier knowingly to take advantage of the fact that a consumer was substantially unable to protect the consumer's own interests because of physical or mental disability, illiteracy, ignorance, inability to understand the language of an agreement, or any other similar factor'.

Like section 41, section 40 is also concerned with procedural fairness, specifically, how consent was obtained.¹⁸³ Section 40 deals with unconscionable conduct of a supplier or a supplier's agent. It gives effect to the CPA's aim to protect consumers from 'unconscionable, unfair, unreasonable, unjust or otherwise improper trade practices'.¹⁸⁴

According to section 1 of the CPA, when the word unconscionable is used in relation to any conduct, it means 'having a character contemplated in section 40; or otherwise unethical or improper to a degree that would shock the conscience of a reasonable person'. This definition is simplified by the DTI which states that 'unconscionable conduct refers to behaviour that is unethical or improper'.¹⁸⁵ According to Du Plessis, for conduct to be unconscionable, a substantial amount of impropriety must exist.¹⁸⁶

The scope of section 40 is quite broad because it applies not only to the listed conduct but to 'any other similar conduct as well'.¹⁸⁷ Thus unconscionable conduct may also include contractual negotiations which take place despite no serious or *bona fide* intention to conclude a contract, an abuse of one's right to withdraw one's offer and overlooking the fact that one might not be able to perform in future.¹⁸⁸

¹⁸³ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 24.

¹⁸⁴ Section 3(1)(d)(i).

¹⁸⁵ Department of Trade and Industry 'The Consumer Protection Act Your Guide to Consumer Rights & How to Protect Them' 23 November 2016 available at https://www.thedti.gov.za/business_regulation/acts/CP_Brochure.pdf (accessed on 12 November 2018).

¹⁸⁶ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 25.

¹⁸⁷ *Ibid* 26.

¹⁸⁸ Hawthorne 'Public governance: Unpacking the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 355.

Section 40(1) refers to a situation in which a consumer cannot exercise their will freely because of the conduct of the supplier or the supplier's agent. This is regardless of whether or not the supplier or the agent engaged in the conduct knowingly.¹⁸⁹

It is necessary to understand each form of conduct stipulated in section 40(1) in order to understand what amounts to unconscionable conduct.¹⁹⁰ Absolute force refers to physical force but could also encompass threats of physical force, however, this may be equivalent to coercion or duress.¹⁹¹ Where an agreement was concluded because of absolute force, the agreement will be void *ab initio*.¹⁹²

Du Plessis points out that coercion is a foreign concept with no established definition in South African contract law.¹⁹³ According to the *Webster Comprehensive Dictionary*, coercion means 'forcible constraint or restraint, moral or physical; compulsion'.¹⁹⁴ Therefore Du Plessis argues that the word coercion is redundant because of the inclusion of the word duress which is a concept that is known in South African law.¹⁹⁵ In the case of duress, it is acceptable for a person to have exercised their will. The focus here is on how fear was instilled, and consent obtained. Duress involves the use of unlawful threats to induce the conclusion of a contract.¹⁹⁶

Undue influence was defined in the case of *Preller and Others v Jordaan*.¹⁹⁷ It is essentially a situation in which one party acquires an influence over the other and such influence impairs the latter's resistance with the result that they cannot exercise their own will.¹⁹⁸ The influence is used to conclude a transaction that is to the weaker party's

¹⁸⁹ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 26.

¹⁹⁰ This list is not, however, exhaustive. Moore Stephens 'Consumer Protection Act guide' available at <https://southafrica.moorestephens.com/MediaLibsAndFiles/media/southafricaweb.moorestephens.com/Guides-2018/MS-Consumer-Protection-Act-Guide.pdf> (accessed on 12 November 2018).

¹⁹¹ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 27.

¹⁹² Jacobs, Stoop and Van Niekerk 'Fundamental Consumer Rights Under the Consumer Protection Act 68 of 2008: A Critical Overview and Analysis' (2010) 13 (3) *PER/PELJ* 347.

¹⁹³ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 27-28.

¹⁹⁴ Marckwardt, Cassidy and McMillan (eds) *Webster Comprehensive Dictionary* International Edition (1977) Vol. 1: 255.

¹⁹⁵ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 27.

¹⁹⁶ *Ibid* 29.

¹⁹⁷ 1956 (1) SA 483 (A).

¹⁹⁸ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 28.

detriment and is a transaction that the weaker party would not have ordinarily consented to. Where undue influence is the cause of a contract, the contract is voidable at the election of the consumer.¹⁹⁹

Du Plessis notes that suppliers exert 'pressure' on consumers in order to persuade them to act in a particular way.²⁰⁰ Suppliers appeal to a customer's insecurities and fears, however, these attempts by suppliers are usually harmless. Furthermore, it is difficult to determine when pressure will amount to unconscionable conduct that cannot be covered under any of the other section 40(1) grounds.²⁰¹

One definition of 'harass' is 'to trouble or worry persistently with cares, annoyances etc.'²⁰² In the context of section 40(1), harassment entails an invasion of personal space for example in the form of spam emails and persistent phone calls.²⁰³

'Tactic' is defined as 'an action or plan that is intended to achieve something'.²⁰⁴ 'Unfair tactics' indicates that that action or plan is unacceptable in some way. Unfair tactics could possibly include exploiting weak persons other than those covered by section 40(2).²⁰⁵

The forms of conduct discussed above are prohibited when marketing goods and services as well and when negotiating, concluding, executing or enforcing an agreement to supply goods and services to a consumer.²⁰⁶

With regard to section 40(2), if the consumer informs the supplier that they are unable to read the agreement or do not understand the language contained therein but the supplier proceeds to carry out the agreement, that is likely to be unconscionable.²⁰⁷

¹⁹⁹ Jacobs, Stoop and Van Niekerk 'Fundamental Consumer Rights Under the Consumer Protection Act 68 of 2008: A Critical Overview and Analysis' (2010) 13 (3) *PER/PELJ* 347.

²⁰⁰ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 29.

²⁰¹ Ibid.

²⁰² Marckwardt, Cassidy and McMillan (eds) *Webster Comprehensive Dictionary* International Edition (1977) Vol. 1: 574.

²⁰³ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 30-31.

²⁰⁴ Soanes (ed) *South African Pocket Oxford Dictionary* 3 ed (2006) 925.

²⁰⁵ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 31.

²⁰⁶ Sections 40(1)(a) and 40(1)(c).

²⁰⁷ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 34.

This is because unlike section 40(1), under section 40(2) the supplier must have been aware of the weakness.

The same applies to 'ignorance'. Ignorance could be a general lack of education on the part of the consumer or a lack of specific knowledge pertaining to the consumer's interaction with the supplier.²⁰⁸

It is suggested that 'any other similar factor' could encompass immaturity and inexperience which results in the consumer being generally unable to form a proper judgment.²⁰⁹

According to the *Cambridge Online Dictionary*, to take advantage of someone means 'to use someone's weakness to improve your situation'.²¹⁰ Thus, section 40(2) means that the supplier must have exploited the consumer's weakness for the supplier's benefit.

In order to ensure that section 40(2) is not contravened, a supplier must make certain that the agreement is understood by the relevant consumer and that the consumer is capable of protecting their interests.²¹¹

Overall, section 40 emphasises that parties to an agreement ought to act in good faith and should abstain from engaging in improper or unconscionable conduct or conduct that is contrary to public policy.²¹² In cases where there has been unconscionable conduct, the avenues of recourse available in section 69 are applicable.²¹³

Both unconscionable conduct (section 40) and false, misleading or deceptive representations (section 41) are deemed prohibited conduct under the CPA.²¹⁴ Thus, if it is concluded by the NCC that an arrangement, agreement, practice or scheme does not amount to a pyramid scheme, a consumer who suffered as a result thereof

²⁰⁸ Ibid.

²⁰⁹ Ibid.

²¹⁰ The definition can be found on the Cambridge Online Dictionary website available at <https://dictionary.cambridge.org/dictionary/english/take-advantage-of-someone> (accessed on 14 November 2018).

²¹¹ Stoop 'The Consumer Protection Act 68 of 2008 and Procedural Fairness in Consumer Contracts' (2015) 18(4) *PER/PELJ* 1113.

²¹² Ibid 1112 footnote 77.

²¹³ These include approaching the NCT, an ombud with jurisdiction, an accredited industry ombud, a consumer court with jurisdiction, an alternative dispute resolution agent, the NCC or, as a last resort, a court with jurisdiction.

²¹⁴ Section 51 of the CPA.

is not necessarily without recourse. If the perpetrators of a scheme or other arrangement acted in a manner that was unconscionable when marketing or negotiating an agreement with a consumer, or made false or misleading misrepresentations, the consumer may approach a civil court that has the power to ensure fair and just conduct, terms and conditions.²¹⁵ If the court determines that a transaction or part of a transaction was unfair or unconscionable, it can make a number of orders including ordering that money be restored to the consumer and that the consumer be compensated for any losses.²¹⁶ The consumer can approach a court as courts are authorised to deal with contraventions of sections 40, 41 and 48.²¹⁷

3.4 Enforcement of the Act

3.4.1 The National Consumer Commission

The NCC is an organ of state which has been established in terms of Chapter 5, Part B of the CPA.²¹⁸ The jurisdiction of the NCC extends throughout the Republic.²¹⁹ The Commission serves as the primary enforcement body for the CPA²²⁰ and receives and investigates complaints concerning allegedly prohibited conduct or offences.²²¹ It also monitors the consumer market with a view to preventing prohibited practices from occurring and to prosecute offenders should such practices be detected.²²² In addition, the Commission deals with the issue and enforcement of compliance notices.²²³ The CPA permits the NCC to issue a compliance notice to anyone who has contravened the CPA by engaging in conduct which the Act deems prohibited.²²⁴ Should the person on whom the notice is served fail to abide by it, the NCC has the option of either referring the matter for prosecution by the NPA or applying to the National Consumer Tribunal (NCT) seeking the imposition of an administrative fine.²²⁵

²¹⁵ Section 52 of the CPA.

²¹⁶ Section 52 (3) of the CPA.

²¹⁷ Section 52 of the CPA.

²¹⁸ Havenga ... et al *General Principles of Commercial Law* 7 ed (2010) 508.

²¹⁹ Section 85(1)(a) of the CPA.

²²⁰ Havenga ... et al *General Principles of Commercial Law* 7 ed (2010) 508.

²²¹ Section 99(b) of the CPA.

²²² Melville *The Consumer Protection Act made easy* 2 ed (2011) 134.

²²³ Ibid.

²²⁴ Section 100(1).

²²⁵ Havenga ... et al *General Principles of Commercial Law* 7 ed (2010) 508.

3.4.2 The National Consumer Tribunal

Chapter 2, Part B of the National Credit Act (the NCA)²²⁶ establishes the NCT. Like the NCC, the Tribunal has jurisdiction throughout the Republic.²²⁷ It has functions similar to a court and has similar status to that of a High Court.²²⁸ The NCT conducts hearings regarding complaints pertaining to both the NCA and the CPA and adjudicates on such matters.²²⁹ Section 73(2)(b) of the NCA empowers the NCT to deal with referrals from the NCC alleging prohibited conduct.

Some of the orders the NCT can make where prohibited conduct is concerned include; declaring that the conduct is prohibited, issuing an interdict and imposing administrative fines.²³⁰ However like CAFCOM, the NCT cannot order damages.²³¹

In terms of section 151(2) of the NCA and section 112(2) of the CPA, an administrative fine 'may not exceed the greater of (a) 10 per cent of the respondent's annual turnover during the preceding financial year; or (b) R1 000 000'. Failure to comply with an NCT order may result in a fine, imprisonment for not more than 10 years or both.²³²

If the matter was heard by only one member of the NCT, the decision may be appealed before a full panel.²³³ If the matter was heard by the full panel, the participant in the hearing can, upon application to the High Court, have the decision reviewed or appeal against it.²³⁴

3.5 The CPA and the Common Law

The CPA does not alter the common law in its entirety,²³⁵ nor does it take away any rights consumers have under the common law.²³⁶ The common law recognises fraud as both a crime and a delict.²³⁷ If a contract was fraudulently induced, the innocent

²²⁶ Act 34 of 2005.

²²⁷ Section 26(1)(a) of the NCA.

²²⁸ Havenga ... et al *General Principles of Commercial Law* 7 ed (2010) 207.

²²⁹ Ibid.

²³⁰ Section 150 of the NCA.

²³¹ Woker 'Why the need for consumer protection legislation? A look at some of the reasons behind the promulgation of the National Credit Act and the Consumer Protection Act' (2010) 31(2) *Obiter* 221.

²³² Section 160 read with section 161 of the NCA.

²³³ Section 148(1) of the NCA.

²³⁴ Section 142(a) and (b) of the NCA.

²³⁵ Melville *The Consumer Protection Act made easy* 2 ed (2011) 22.

²³⁶ Section 2(10) of the CPA.

²³⁷ Melville *The Consumer Protection Act made easy* 2 ed (2011) 55.

party is entitled to institute legal proceedings against the wrongdoer in order to have the contract set aside. In addition, the innocent party can claim damages.²³⁸ With the enactment of the CPA, certain practices are specified as being prohibited, with the result being that an administrative fine is imposed on anyone found to be engaging in such practices.²³⁹

A contravention of section 43 could also result in the guilty party being charged with fraud.²⁴⁰ Fraud may be defined as 'unlawfully making, with intent to defraud, a misrepresentation which causes actual prejudice or which is potentially prejudicial to another'.²⁴¹ It is argued that the perpetrators of a pyramid scheme, by promoting and participating in the scheme, unlawfully and intentionally make misrepresentations to potential recruits.²⁴² These misrepresentations relate to the fact that the scheme is a 'no-fail investment opportunity'.²⁴³ These misrepresentations have the effect of prejudicing or potentially prejudicing others because if they fall in the lower levels of the pyramid, they stand to lose their initial investment and it is unlikely that they will generate any profit as promised at the outset.²⁴⁴ According to section 2(10) of the CPA, 'no provision of this Act must be interpreted so as to preclude a consumer from exercising any rights afforded in terms of the common law'. Thus, perpetrators of pyramid schemes may be charged with fraud.

3.6 Conclusion

South Africa is attune to the problem of pyramid schemes in the country. The DTI took action in 1980 and imposed conditions regulating pyramid schemes, however, these conditions proved cumbersome rather than effective. They were replaced by the Business Practices Act of 1988 and its subsequent amendment, the Consumer Affairs

²³⁸ Ibid.

²³⁹ Ibid 55.

²⁴⁰ Majola and Dini 'All that glitters: an exploration of the Pyramid Scheme and Ponzi Scheme phenomena and what the law is doing to protect consumers' 15 July 2015 available at <https://www.lexology.com/library/detail.aspx?g=c62b13a4-d053-48d5-bef2-3b1ac7a85351> (accessed on 21 February 2018).

²⁴¹ Hunt *South African Criminal Law and Procedure* 1970 2 714.

²⁴² Majola and Dini 'All that glitters: an exploration of the Pyramid Scheme and Ponzi Scheme phenomena and what the law is doing to protect consumers' 15 July 2015 available at <https://www.lexology.com/library/detail.aspx?g=c62b13a4-d053-48d5-bef2-3b1ac7a85351> (accessed on 21 February 2018).

²⁴³ Ibid.

²⁴⁴ Ibid.

(Unfair Business Practices) Act. Under this Act, the BPC (renamed CAFCOM) was empowered to conduct either general or specific investigations into harmful (thereafter unfair) business practices. These investigations yielded three common practices, one of which was promotional pyramid schemes. If the Minister of Trade and Industry agreed that the scheme which was the subject of the investigation was unfair, he could declare the scheme prohibited and order that the practice be discontinued. The problem with this, however, was that a breach in the Minister's order could only be dealt with by the SAPS or NPA, bodies which were already inundated with criminal matters.

The Consumer Affairs (Unfair Business Practices) Act was the immediate predecessor of the CPA. Despite the Act being replaced by the CPA, the CAFCOM investigations influenced section 43 of the CPA. Section 43 expressly prohibits pyramid and other related schemes. In addition, section 43(6) allows the Minister to declare schemes which have an effect similar to a pyramid scheme as prohibited. Both the promotion of and participation in these schemes is deemed unlawful. Moreover, the CPA also prohibits false, misleading and deceptive representations as well as unconscionable conduct thus providing the consumer with alternative avenues should they discover that they have become involved in a scheme which contravenes the CPA, whether it be a pyramid scheme, or they have been misled about the true nature of the business opportunity they have invested in.

The NCC is tasked with investigating complaints and may issue a compliance notice where prohibited conduct is concerned. Thus, for example, the NCC may issue a notice informing the business that it must cease promoting its scheme, refund consumers their investments or stop using certain advertising or marketing strategies as these are, for example, misleading. Failure to comply with a compliance notice may result in either prosecution by the NPA or further investigation by the NCT.

The NCT is empowered to impose administrative penalties of up to R1 million or 10% of a business's annual turnover. Therefore, even if a business does not go as far as becoming a pyramid scheme, there may be other aspects of the business, such as the manner in which it is being promoted, which contravenes the CPA.

Aggrieved consumers can also approach the normal civil courts and ask for a remedy in terms of section 52 (3) of the CPA which may mean they are able to claim a refund

of their investment and any other costs which they have incurred. Perpetrators of pyramid schemes may also be charged with the criminal offence of fraud under the common law.

Chapter 4

Herbalife and the American experience

4.1 Introduction

As mentioned previously, Herbalife is an international direct selling company involved in the production, promotion and sales of nutritional products.²⁴⁵ These include sport supplements and products which assist with weight management. The name Herbalife has become synonymous with the term pyramid scheme with many allegations being directed at the company and, in particular, its compensation structure. To determine whether these allegations have any merit, Herbalife's business model will be considered, as will the facts, findings and outcome of the FTC investigation undertaken in the United States of America. This will be followed by an overview of the current legal debates surrounding Herbalife in the United States.

4.2 Criticisms of Herbalife

Many have criticised Herbalife claiming that its business operations are closer to a pyramid scheme rather than an MLM company. In the United States, one such accusation was made by television show host, John Oliver, who, on his show *Last Week Tonight*, publicly exposed Herbalife claiming that its so-called business opportunity was in fact a scam.²⁴⁶ Another notable allegation was made in December 2012 by Bill Ackman, a hedge fund manager who founded Pershing Square Capital Management.²⁴⁷ Ackman's claim that Herbalife was a pyramid scheme triggered the FTC investigation.²⁴⁸ Among the reasons advanced by Ackman in support of his

²⁴⁵ Herbalife International of America, Inc and Herbalife International, Inc. are subsidiaries of Herbalife Nutrition Ltd (formally Herbalife Ltd). They will collectively be referred to as Herbalife or the company. *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 3.

²⁴⁶ Multilevel Marketing: Last Week Tonight with John Oliver (HBO) available at <https://www.youtube.com/watch?v=s6MwGeOm8il> accessed on 21 February 2018.

²⁴⁷ Ahuja and Kelly 'Herbalife Disputes Ackman's Claim of 'Pyramid Scheme' 19 December 2012 available at <https://www.cnbc.com/id/100328657> (accessed on 17 October 2018).

²⁴⁸ Oydele 'Herbalife is surging after a report that the company has settled its FTC investigation' 24 May 2016 available at <https://www.businessinsider.com/report-herbalife-ftc-agreement-2016-5?IR=T> (accessed on 8 November 2018).

accusation was that Herbalife misrepresented to new members the income they could make by pursuing the Herbalife opportunity.²⁴⁹ In addition, the company did not disclose that it was highly unlikely that members would make a substantial income and that the majority of rewards advertised by the company were earned by Herbalife's top 1% of distributors.²⁵⁰ Ackman also asserted that the company incentivised recruitment and made use of recruiting materials that were materially deceptive.²⁵¹ He also accused the company's nutrition clubs, which serve as a means of recruiting more members, of having the characteristics of pyramid schemes.²⁵² One of Ackman's key criticisms related to Herbalife's compensation structure. He claimed that the distributors were compensated in a manner more akin to pyramid schemes than MLM programmes.²⁵³

4.3 Herbalife's response

In a press release dated 20th December 2012, Herbalife responded to Ackman's allegations and expressly stated that, 'Herbalife is not an illegal pyramid scheme'.²⁵⁴ The company asserted that its business practices and products were constantly reviewed and external experts ensured that Herbalife operated in accordance with the law.²⁵⁵ Herbalife also disclosed the findings from an economic analysis of its business practices. According to the findings in this analysis, Herbalife conducted its business like an MLM model and not in a pyramidal-like manner.²⁵⁶ The analysis also revealed

²⁴⁹ Conversano 'The War Against Herbalife: Pyramid Scheme or Multi-Level Marketing Master?' 2015 available at

http://www.fraudconference.com/uploadedFiles/Shared_Content/Course_Materials/26th/ppt/9A-James-Conversano.pdf (accessed on 9 October 2018).

²⁵⁰ Ibid.

²⁵¹ Ibid.

²⁵² Majola and Dini 'All that glitters: an exploration of the Pyramid Scheme and Ponzi Scheme phenomena and what the law is doing to protect consumers' 15 July 2015 available at <https://www.lexology.com/library/detail.aspx?g=c62b13a4-d053-48d5-bef2-3b1ac7a85351> (accessed on 21 February 2018).

²⁵³ Conversano 'The War Against Herbalife: Pyramid Scheme or Multi-Level Marketing Master?' 2015 available at

http://www.fraudconference.com/uploadedFiles/Shared_Content/Course_Materials/26th/ppt/9A-James-Conversano.pdf (accessed on 9 October 2018).

²⁵⁴ 'Herbalife Statement in Response to Ackman Presentation' 20 December 2012 available at <https://ir.herbalife.com/news-releases/news-release-details/herbalife-statement-response-ackman-presentation> (accessed on 9 October 2018).

²⁵⁵ Ibid.

²⁵⁶ 'Prominent Expert Economist and Former FTC Advisor Provides Analysis of the Herbalife Business Model' 22 July 2014 available at <https://www.marketwatch.com/press-release/prominent-expert->

that Herbalife provides members with a 'reasonable prospect of operating a financially successful business'.²⁵⁷ Michael Johnson, who was the CEO of Herbalife at the time, denied Ackman's allegations and was reported to have said that the company does not pay for recruiting.²⁵⁸

4.4 Herbalife's Sales and Marketing Plan

In order to assess whether the criticisms levelled against Herbalife (i.e. that it operates as a pyramid scheme) have any merit, it is necessary to understand its Sales and Marketing Plan. Herbalife operates a multi-level Sales and Marketing Plan with the lowest level occupied by distributors or members and the highest level being President's Team.²⁵⁹ There are different benefits associated with every level that help determine how members are compensated.²⁶⁰

There are two main ways in which members can generate an income. Firstly, members can derive profits from their resale of Herbalife products, after having subtracted their expenses.²⁶¹ This is known as profit on own sales.²⁶² Secondly, members may choose

economist-and-former-ftc-advisor-provides-analysis-of-the-herbalife-business-model-2014-07-22 (accessed on 9 October 2018).

²⁵⁷ Ibid.

²⁵⁸ Ahuja and Kelly 'Herbalife Disputes Ackman's Claim of 'Pyramid Scheme' 19 December 2012 available at <https://www.cnbc.com/id/100328657> (accessed on 17 October 2018).

²⁵⁹ As of 2013, distributors became known as members. However, this did not result in any substantive change to Herbalife's business opportunity. The words distributor and member will thus be used interchangeably. *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 4.

²⁶⁰ Herbalife 'Discover the Herbalife Opportunity Sales & Marketing Plan' 2 June 2015 available at https://edge.myherbalife.com/vmba/media/2FFABAFF-B277-4B32-80E4-C6014920D7BD/Web/General/Original/Sales%20%20Marketing%20Plan%20Section_Update%20Nov%202015.pdf (accessed on 17 September 2018).

²⁶¹ Expenses include but are not limited to 'advertising or promotional expenses, product samples, training, rent, travel, telephone and Internet costs, and miscellaneous expenses'. Herbalife 'Sales and Marketing Plan' May 2014 page 20 available at <http://assets.factsabouthherbalife.com/content/uploads/2015/10/26133816/SalesAndMarketingPlan.pdf> (accessed on 9 July 2018).

²⁶² Ibid.

to sponsor others,²⁶³ thereby enabling those that they sponsor to become members.²⁶⁴ In this way the sponsors form individual downline sales organisations. Members are not financially compensated simply for introducing or sponsoring new members, instead, they are compensated for products sold to their downline either for personal consumption or for resale. This is termed multilevel compensation.²⁶⁵

Every Herbalife product is allocated a Volume Point value.²⁶⁶ Members earn credit for products ordered (volume) and this is calculated using the Volume Points of the products concerned. The points accumulated are used to calculate the qualifications and benefits a member is eligible to receive.²⁶⁷

When members purchase products, they receive a discount, known as a wholesale discount,²⁶⁸ which ranges from 25% to 50% off earn base.²⁶⁹ These products are then sold to customers. The difference between the selling price (what the customer pays) and the cost price (what the member paid) is known as the member's retail profit.²⁷⁰

Members can also earn commission (also known as wholesale profit) on products purchased by their downline.²⁷¹ The difference in the cost which members pay and the discounted amount which is paid by their downline equates to wholesale profit.²⁷²

²⁶³ A sponsor is 'a member who brings another individual into Herbalife'. Herbalife 'Discover the Herbalife Opportunity Sales & Marketing Plan' 2 June 2015 page 25 available at https://edge.myherbalife.com/vmba/media/2FFABAFF-B277-4B32-80E4-C6014920D7BD/Web/General/Original/Sales%20%20Marketing%20Plan%20Section_Update%20Nov%202015.pdf (accessed on 17 September 2018).

²⁶⁴ Herbalife 'Sales and Marketing Plan' May 2014 page 20 available at <http://assets.factsaboutherbalife.com/content/uploads/2015/10/26133816/SalesAndMarketingPlan.pdf> (accessed on 9 July 2018).

²⁶⁵ Ibid.

²⁶⁶ Herbalife 'Discover the Herbalife Opportunity Sales & Marketing Plan' 2 June 2015 page 8 available at https://edge.myherbalife.com/vmba/media/2FFABAFF-B277-4B32-80E4-C6014920D7BD/Web/General/Original/Sales%20%20Marketing%20Plan%20Section_Update%20Nov%202015.pdf (accessed on 17 September 2018).

²⁶⁷ Ibid.

²⁶⁸ Ibid 11.

²⁶⁹ Earn base value is defined as 'the value assigned to a product, in local currency, on which discounts and earnings are calculated'. Ibid 24.

²⁷⁰ Ibid 11.

²⁷¹ Ibid.

²⁷² Ibid.

If a member's total volume increases, they may become a senior consultant.²⁷³ As a senior consultant they are entitled to a discount of 35% to 42% off earn base when purchasing products and stand to make a greater profit.²⁷⁴

In addition to retail and wholesale profit, those who reach the level of Herbalife supervisor can also earn royalty overrides of 1% to 5%.²⁷⁵ Royalty overrides are calculated on a supervisor's monthly total volume. However, if a supervisor earns less than 500 volume points, they do not qualify for royalty overrides. If a supervisor earns 2500 volume points or more, they receive the maximum 5% on three of their active downline levels. In addition to meeting the aforementioned requirements, supervisors must adhere to the 10 Retail Customers Rule²⁷⁶ and the 70% Rule²⁷⁷ in order to qualify for royalty overrides.

A supervisor may also be eligible for royalty override roll-ups.²⁷⁸ This occurs when a supervisor who earns a 5% royalty override has downline royalty contributing supervisors who do not earn the maximum 5% royalty override. The override roll-up earned by the supervisor is equivalent to 5% minus the percentage override actually earned by the contributing supervisor.²⁷⁹

If a supervisor goes on to achieve Top Achievers Business (TAB) Team status, they qualify for a production bonus which is based on the volume of their entire organisation, with the minimum bonus being 2% and the maximum 7%.²⁸⁰ This is paid to the TAB team on a monthly basis. To qualify for a production bonus, the team must also abide by the 10 Retail Customers Rule and the 70% Rule.²⁸¹ A TAB team can

²⁷³ Total Volume is equivalent to Personal Volume plus Group Volume. Personal Volume is 'the volume from orders purchased by you as a Fully Qualified Supervisor and all others in your downline organization, excluding any 50% orders by Qualifying or Qualified Supervisors'. Group Volume is defined as 'orders purchased at a temporary 50% discount, by Qualifying Supervisor(s) in a Supervisor's personal organization'. Ibid 25.

²⁷⁴ Ibid 12.

²⁷⁵ Ibid 17.

²⁷⁶ According to this rule 'a Member must make sales to at least 10 separate retail customers each month to qualify and receive Royalty Overrides and Production Bonus'. Ibid 25.

²⁷⁷ According to this rule 'in any given month, a Member must sell to retail customers, and/or sell at wholesale to downline Members, at least 70% of the total value of Herbalife products they hold for resale, in order to qualify for TAB Team and to earn and receive Royalty Overrides and Production Bonus for that month's business'. Ibid.

²⁷⁸ Ibid 17.

²⁷⁹ Ibid.

²⁸⁰ Ibid 19.

²⁸¹ Ibid.

also earn a production bonus on another TAB team in their downline if that team has a lower production bonus percentage. This production bonus will be the difference between the TAB team's production bonus percentage and the downline TAB team's production bonus percentage.²⁸² The production bonus is regarded as a reward for a TAB team's leadership and loyalty.²⁸³

Some of Herbalife President's Team members may receive an additional bonus known as the Mark Hughes Bonus. This is an annual bonus awarded to members who displayed superior leadership and motivation during the preceding year,²⁸⁴ and is also an acknowledgement of their role in the sale of Herbalife products.²⁸⁵ This bonus can be a maximum of 1% of the company's worldwide sales.²⁸⁶

Herbalife members may also receive recognition awards such as pins, plaques and jewellery, upon reaching a certain level or obtaining a certain qualification.²⁸⁷ Members may sometimes also qualify for Herbalife vacations and training events.²⁸⁸

²⁸² If both TAB teams attain the same production bonus percentage, the upline team can earn on the downline team but not on that team's downline. If a downline team earns a higher production bonus than an upline team, the upline team cannot earn a production bonus on the downline team or their downline. Herbalife 'Sales and Marketing Plan' May 2014 page 25 available at <http://assets.factsabouth Herbalife.com/content/uploads/2015/10/26133816/SalesAndMarketingPlan.pdf> (accessed on 9 July 2018).

²⁸³ Herbalife 'Discover the Herbalife Opportunity Sales & Marketing Plan' 2 June 2015 page 19 available at https://edge.myherbalife.com/vmba/media/2FFABAFF-B277-4B32-80E4-C6014920D7BD/Web/General/Original/Sales%20%20Marketing%20Plan%20Section_Update%20Nov%202015.pdf (accessed on 17 September 2018).

²⁸⁴ Coughlan 'Assessing an MLM Business: Herbalife as a Legitimate MLM' July 2012 available at https://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/Assessing%20an%20MLM%20Business%20HLF%20as%20a%20Legit%20MLM%207-30-2012%20FINAL.pdf (accessed on 18 July 2018).

²⁸⁵ Herbalife 'HOM Digital Flipbook USEN- Herbalife Nutrition' available at <https://herbalifeevents.com/hrbl/hom-digital-flipbook-usen/> (accessed on 17 September 2018).

²⁸⁶ Coughlan 'Assessing an MLM Business: Herbalife as a Legitimate MLM' July 2012 available at https://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/Assessing%20an%20MLM%20Business%20HLF%20as%20a%20Legit%20MLM%207-30-2012%20FINAL.pdf (accessed on 18 July 2018).

²⁸⁷ Herbalife 'Discover the Herbalife Opportunity Sales & Marketing Plan' 2 June 2015 page 20 available at https://edge.myherbalife.com/vmba/media/2FFABAFF-B277-4B32-80E4-C6014920D7BD/Web/General/Original/Sales%20%20Marketing%20Plan%20Section_Update%20Nov%202015.pdf (accessed on 17 September 2018).

²⁸⁸ Ibid 19.

4.4.1 Key criticisms of this Sales and Marketing Plan

Those who criticise this Sales and Marketing Plan have identified the following key problem areas:

- members need to purchase high quantities of products;
- the products are very costly;²⁸⁹
- there is an underlying element of deception to the scheme;²⁹⁰
- revenues are not distinguished from profits;
- the costs associated with being a distributor are not revealed;²⁹¹
- Herbalife has a very complex commission structure;²⁹²
- sponsors do not properly explain how members will progress in the compensation hierarchy and there are many difficulties associated with trying to progress;²⁹³
- difficulties associated with certain forms of compensation in particular are not explained;²⁹⁴
- the company places a great deal of emphasis on recruitment; and
- only a small minority seem to benefit financially.²⁹⁵

To elaborate, critics argue that in order to be eligible for and benefit from Herbalife bonuses, distributors and their recruits need to purchase many products.²⁹⁶ These products are overpriced and exploit poor consumers who are deceived into purchasing products they are incapable of selling or do not wish to consume.²⁹⁷ Despite the cost of these products and the fact that there is a good chance they will not be sold or used

²⁸⁹ Partnoy 'Is Herbalife a Pyramid Scheme?' June 2014, available at <https://www.theatlantic.com/magazine/archive/2014/06/wall-streets-6-billion-mystery/361624/> (accessed on 18th April 2018).

²⁹⁰ Ibid.

²⁹¹ Ibid.

²⁹² Criticisms about Herbalife's compensation plan can be found on the Facts About Herbalife website available at <https://www.factsaboutherbalife.com/the-facts/the-herbalife-compensation-plan/> (accessed on 8 November 2018).

²⁹³ Ibid.

²⁹⁴ Ibid.

²⁹⁵ Arguments as to why Herbalife's compensation plan resembles a pyramid scheme can be found on the Facts About Herbalife website available at <https://www.factsaboutherbalife.com/the-facts/the-herbalife-pyramid-scheme/> (accessed on 8 November 2018).

²⁹⁶ Partnoy 'Is Herbalife a Pyramid Scheme?' June 2014, available at <https://www.theatlantic.com/magazine/archive/2014/06/wall-streets-6-billion-mystery/361624/> (accessed on 18th April 2018).

²⁹⁷ Ibid.

by the members, members buy products because the purchase is coupled with a perceived business opportunity.²⁹⁸ Consumers labour under the false impression that by simply participating in the scheme they will be able to derive a substantial income.²⁹⁹

This impression is created in part by Herbalife's complex commission structure.³⁰⁰ The perception is that because there are multiple ways to earn income with Herbalife, it is easy to do so. Critics disagree with this perception claiming that it is difficult to earn money from these various streams and to do so requires massive downlines.³⁰¹ Moreover, sponsors do not inform recruits of this difficulty. Recruits are merely told that in order to advance in the compensation hierarchy they need to put in hard work and effort.³⁰² Production bonuses in particular pose a problem because they are payable on infinite levels.³⁰³ In other words, a distributor will receive a production bonus on each level of their downline regardless of how many levels there are. This is problematic because it is a further indication that Herbalife incentivises recruitment.³⁰⁴

The promotional vacations offered by Herbalife are also criticised. These promotions usually have high qualification thresholds and result in upline distributors pressurising their downlines to purchase many products, to meet the threshold, even though there is no consumer demand for the products.³⁰⁵ Herbalife products may also be difficult to sell because similar products can be found at retail stores where they are not as expensive.³⁰⁶ Furthermore, Herbalife does not divulge the number of other distributors who are selling products in a particular area. This failure to disclose can result in distributors competing for the same consumer market.³⁰⁷ A further problem exists when there are higher-level distributors working in the same market as entry-level distributors. Higher-earning distributors qualify for greater discounts on products, so

²⁹⁸ Harris 'Herbalife a "pyramid scheme"?' 31 December 2012 available at <https://www.camcheck.co.za/herbalife-a-pyramid-scheme/> (accessed on 8 November 2018).

²⁹⁹ Ibid.

³⁰⁰ Criticisms about Herbalife's compensation plan can be found on the Facts About Herbalife website available at <https://www.factsaboutheralife.com/the-facts/the-herbalife-compensation-plan/> (accessed on 8 November 2018).

³⁰¹ Ibid.

³⁰² Ibid.

³⁰³ Ibid.

³⁰⁴ Ibid.

³⁰⁵ Ibid.

³⁰⁶ Ibid.

³⁰⁷ Ibid.

it is possible for them to sell those products at a lower cost than entry-level distributors. This makes it even more difficult for newer distributors to find consumers.

The Herbalife compensation and commission structure is criticised as a whole for operating in a way that only allows those at the top of the compensation plan to prosper financially. These top-level distributors will prosper at the expense of those at the bottom of the commission structure.³⁰⁸ It is argued that only a few distributors who join Herbalife will make money and their profits are derived from recruiting new members, convincing them to purchase products and encouraging them to recruit others. This is possibly the main criticism of the Herbalife Sales and Marketing Plan because it resonates with the principal feature of a pyramid scheme namely, income is derived primarily through the introduction of new recruits as opposed to the sale of goods or services to consumers. Upline distributors advance in the company hierarchy, obtain greater discounts and they receive commission when distributors below them purchase Herbalife products from the company, hence, distributors are incentivised to recruit and are essentially paid to recruit.³⁰⁹

4.5 Arguments in favour of Herbalife as a legitimate MLM programme

The view that Herbalife is a pyramid scheme is not supported by all. Those who oppose this view highlight certain characteristics of Herbalife's Sales and Marketing Plan and its business model which, it is argued, demonstrate that it is a legitimate MLM programme.

Coughlan, a professor of marketing, argues that Herbalife distributors are compensated based on their role in generating product sales and not for mere recruitment.³¹⁰ She argues further that the registration fee payable by members upon joining the organisation is low. Upon registration, members are required to purchase

³⁰⁸ Ibid.

³⁰⁹ Arguments as to why Herbalife's compensation plan resembles a pyramid scheme can be found on the Facts About Herbalife website available at <https://www.factsaboutherbalife.com/the-facts/the-herbalife-pyramid-scheme/> (accessed on 8 November 2018).

³¹⁰ Coughlan 'Assessing an MLM Business: Herbalife as a Legitimate MLM' July 2012 available at https://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/Assessing%20an%20MLM%20Business%20HLF%20as%20a%20Legit%20MLM%207-30-2012%20FINAL.pdf (accessed on 18 July 2018).

either a Mini International Business Pack (IBP) or a full IBP.³¹¹ The mini IBP includes, amongst other things, samples of Herbalife products while the full IBP contains some full-sized products. At that time, in the United States, the price of the mini IBP was \$57.75 and the full IBP was \$95.55.³¹² According to Coughlan this was lower than the median cost of starter kits which the United States Direct Selling Association reported to be \$99. It should be noted, however, that the cost of these packs has since escalated. As of November 2017, the IBP cost approximately \$94.10 and the IBP Super Starter cost \$124.10.³¹³ Both figures exclude tax and shipping.³¹⁴

Coughlan also asserts that, unlike goods sold by pyramid schemes, Herbalife's products are valuable to consumers. Herbalife is committed to ensuring that they produce quality products and it spends a considerable amount of money on scientific research and employs highly qualified staff to do this research.³¹⁵ It is suggested by Coughlan that Herbalife's long-standing history is evidence that its products are valuable to consumers. Herbalife, in its Sales and Marketing Plan also provides a return policy.³¹⁶ If customers are not satisfied with the products they have purchased, they can, subject to the fulfilment of certain conditions, appeal to the member from whom they purchased the products, for a refund. According to Herbalife, this refund policy exists because the company firmly believes in its products and assures the quality thereof.³¹⁷ Coughlan also points out that products are widely sold to consumers

³¹¹ As of 2013, the IBP also became known as the Herbalife Member Pack. *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief 15 July 2016 page 29.

³¹² Coughlan 'Assessing an MLM Business: Herbalife as a Legitimate MLM' July 2012 available at https://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/Assessing%20an%20MLM%20Business%20HLF%20as%20a%20Legit%20MLM%207-30-2012%20FINAL.pdf (accessed on 18 July 2018).

³¹³ Herbalife 'What should I know about being an Herbalife Distributor? U.S. Statement of Average Gross Compensation' 28 November 2017 available at <https://ir.herbalife.com/static-files/2ff07056-59bf-4db9-bb7e-cde4bca50b06> (accessed on 11 October 2018).

³¹⁴ Information regarding the cost of Herbalife member packs is available at <https://www.myherbal.co/hmp-herbalife-member-pack-price/> (accessed on 10 October 2018).

³¹⁵ Coughlan 'Assessing an MLM Business: Herbalife as a Legitimate MLM' July 2012 available at https://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/Assessing%20an%20MLM%20Business%20HLF%20as%20a%20Legit%20MLM%207-30-2012%20FINAL.pdf (accessed on 18 July 2018). See also Herbalife 'Herbalife Statement in Response to Ackman Presentation' 20 December 2012 available at <https://ir.herbalife.com/news-releases/news-release-details/herbalife-statement-response-ackman-presentation> (accessed on 9 October 2018).

³¹⁶ Herbalife 'Sales and Marketing Plan' May 2014 page 26 available at <http://assets.factsabouterherbalife.com/content/uploads/2015/10/26133816/SalesAndMarketingPlan.pdf> (accessed on 9 July 2018).

³¹⁷ Information pertaining to Herbalife's return policy can be found on the Herbalife South Africa website available at <http://www.herbalife.co.za/terms-of-use> (accessed on 11 November 2018).

external to the organisation and not only to other distributors. However, according to Coughlan, this latter point is only relevant in assessing whether a scheme is a pyramid scheme if the products in question have little or no value and sales are driven solely by recruitment.³¹⁸ Her main argument, as stated above, is that the Herbalife products have value for consumers.

Herbalife distributors are also discouraged from engaging in inventory loading.³¹⁹ Distributors are told that products must be purchased in order to be sold to retail customers or distributed through a distributor's downline or should be consumed personally by the distributor and/or their families.

The company also offers a buyback policy which allows members wanting to resign to return, in exchange for a full refund, unopened products which they have purchased within the past year and which remain in their possession.³²⁰ Herbalife will also pay for shipping and, if resignation occurs within a member's first year at Herbalife, they will also be refunded in full for the starter pack purchased.³²¹ Furthermore, within 90 days of joining Herbalife, a distributor is entitled to forgo the business opportunity and their sponsor is obliged to accept this together with the return of any unsold inventory.³²²

4.6 The United States of America investigation

Before considering the actual investigation into Herbalife by the American authorities, it is necessary to have a brief understanding of the applicable law in the United States.³²³

³¹⁸ Coughlan 'Assessing an MLM Business: Herbalife as a Legitimate MLM' July 2012 available at https://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/Assessing%20an%20MLM%20Business%20HLF%20as%20a%20Legit%20MLM%207-30-2012%20FINAL.pdf (accessed on 18 July 2018).

³¹⁹ Ibid.

³²⁰ Herbalife 'HOM Digital Flipbook USEN- Herbalife Nutrition' available at <https://herbalifeevents.com/hrbl/hom-digital-flipbook-usen/> (accessed on 17 September 2018).

³²¹ Ibid.

³²² Coughlan 'Assessing an MLM Business: Herbalife as a Legitimate MLM' July 2012 available at https://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/Assessing%20an%20MLM%20Business%20HLF%20as%20a%20Legit%20MLM%207-30-2012%20FINAL.pdf (accessed on 18 July 2018).

³²³ It is not possible in a mini-dissertation to discuss the law in detail and so only those areas of the law which are relevant are set out in summary below.

4.6.1 The FTC and the FTC Act

The FTC is the American equivalent of the NCC and the NCT.³²⁴ It is an independent government agency whose responsibility includes, *inter alia*, to ensure consumer protection under the Federal Trade Commission Act of 1914 (the FTC Act).³²⁵ The FTC Act is similar to the CPA in that it outlaws certain conduct. Under section 5 of the FTC Act, unfair or deceptive acts and practices are prohibited as well as unfair methods of competition. Section 5 also mandates the disclosure of material terms to a contract. False, misleading and unsubstantiated material representations concerning the income a potential member is likely to earn are an infringement of section 5.³²⁶ A company must be able to substantiate its claims with objective evidence.³²⁷ Claims which are true may not necessarily be a reflection of typical results for example, get-rich-quick advertisements, lifestyle testimonials and hypothetical earnings. If such claims cannot be attained by the majority of members, they may be deemed misleading.³²⁸

The FTC Act empowers the FTC to conduct formal investigations into companies, obtain injunctive relief to prevent further consumer injury and bring administrative enforcement actions with the aim of obtaining financial redress for consumers.³²⁹ Enforcement actions generally result in the conclusion of consent orders,³³⁰ which is the South African equivalent of settlement agreements.

³²⁴ Information regarding the respective consumer protection agencies worldwide can be found on the FTC website available at <https://www.ftc.gov/policy/international/competition-consumer-protection-authorities-worldwide> (accessed on 17 November 2018).

³²⁵ Practical Law Commercial Transactions 'Legitimate Multi-Level Marketing Plans Versus Illegal Pyramid Schemes' 2018 Practical Law Practice Note w-011-5206 available on Thomson Reuters Westlaw (accessed on 13 July 2018).

³²⁶ Ibid.

³²⁷ Ibid.

³²⁸ Ibid.

³²⁹ Ibid.

³³⁰ Ibid.

4.6.2 The FTC investigation into Herbalife

Prompted by the allegations that Herbalife was acting improperly, the FTC launched an investigation into its business model.³³¹ The FTC's argument primarily centred around Herbalife's income misrepresentations. The company claimed that those who joined the scheme could make a substantial income, either part time or full time.³³² This message was communicated through various mediums of advertising such as videos, live presentations, as well as print materials.³³³

The FTC argued that a consideration of its compensation plan revealed that rather than incentivising retail sales, Herbalife incentivised the recruiting of further members who make wholesale purchases of products.³³⁴ The FTC pointed out that retail sales were not very lucrative and were possibly only sufficient to lessen the costs of participating in the programme. It was also established that just a few distributors made money from the Herbalife programme and that instead of making money, many members actually lost money.³³⁵

Although Herbalife sometimes displayed disclaimers in conjunction with the representations it made regarding potential earnings, it was argued that this did not detract from the overall impression that the message sent out by Herbalife created, namely, that distributors could generate a considerable income.³³⁶ It was further argued that these disclaimers were usually in fine print and often contained reference to another document such as Herbalife's Statement of Average Gross Compensation. In order to fully understand the message, distributors would have to access and read further documents. Even if distributors did go to the lengths of reading these documents, it was found that these documents did not convey realistic expectations either.³³⁷

³³¹ Partnoy 'Is Herbalife a Pyramid Scheme?' June 2014, available at <https://www.theatlantic.com/magazine/archive/2014/06/wall-streets-6-billion-mystery/361624/> (accessed on 18th April 2018).

³³² *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 4.

³³³ Ibid 5.

³³⁴ Ibid 4.

³³⁵ Ibid 5.

³³⁶ Ibid.

³³⁷ Ibid 5-6.

Moreover, Herbalife videos, which were accessible on Herbalife websites and included in the mandatory starter pack that distributors purchased, contained images of lavish cars, houses and holiday destinations.³³⁸ These videos also included income testimonials. As a whole, the FTC argued, the message that these videos portrayed was that becoming a Herbalife distributor was an opportunity for earning a substantial income.³³⁹

It was also suggested that at live presentations, Herbalife usually chose, as presenters, those who were among the few who had reached the higher ranks in the company. These presenters repetitively stated that the Herbalife opportunity was one which was accompanied by substantial income, subject only to the effort that was put in by distributors.³⁴⁰ The FTC also noted that these presentations usually involved distributors buying a minimum number of Herbalife products to attend and/or paying a fee to attend.³⁴¹

Herbalife also included print publications, such as a document entitled 'Your Business Basics', which led customers to believe that they could earn additional income on a monthly basis, with no bar to their financial potential, and be successful like thousands of others who had joined Herbalife.³⁴² Another form of print publication was the *Presentation Book* which, from the period of 2012 to 2014, had been included as part of the Herbalife starter pack.³⁴³ This book was created with the intention of being shown to possible recruits. Contained in the book was the statement that Herbalife provided '[t]he opportunity to earn more than you ever thought possible and make your dreams come true!'. Accompanying this statement were pictures of fancy cars, houses, boats and dollar bills.

Distributor testimonials were also contained in the *Presentation Book* as well as in *Herbalife Today*, an online Herbalife magazine. In these testimonials, distributors spoke about how Herbalife had had a life-changing impact on them and how, ever since becoming a member, they had financially prospered.³⁴⁴

³³⁸ Ibid 6.

³³⁹ Ibid 6-8.

³⁴⁰ Ibid 9.

³⁴¹ Ibid.

³⁴² Ibid 11-12.

³⁴³ Ibid 12-13.

³⁴⁴ Ibid.

Herbalife promotional material, such as videos and print material mentioned above, also portrayed to consumers the idea that significant income could be earned through retail sales of Herbalife products.³⁴⁵ It was argued by the FTC that such representations were misleading. This was because Herbalife did not record 'either the existence or profitability of Distributor attempts to retail Herbalife products'.³⁴⁶ This statement can be supported by one made by Des Walsh, former President of Herbalife. When asked how many products were sold to non-Herbalife members, Walsh replied 'we don't track this number and do not believe it is relevant'.³⁴⁷ The company did, however, conduct a survey in 2014, the results of which revealed that only 39% of product sales were to those outside of the organisation.³⁴⁸ According to the FTC, 'the overwhelming majority of Herbalife Distributors who pursue the business opportunity make little or no money from retail sales'.³⁴⁹

The FTC alleged that Herbalife created the impression that its members could obtain a substantial financial benefit from retail sales.³⁵⁰ The FTC claimed that this was partially achieved through the promotion of nutrition clubs.³⁵¹ Herbalife members lease premises or make use of their homes to operate nutrition clubs. Customers are required to pay a membership fee to join the club, following which they may consume certain Herbalife products on site. Customers are not charged individually for the products they consume. A key feature of these clubs, as noted by the FTC, is that products cannot be purchased on site. According to the FTC, the impression created by Herbalife that nutrition clubs generate substantial income for their respective owners is incorrect.³⁵² Instead, club owners most often ran a loss because the associated costs of running the club were greater than the cumulative membership fees collected.³⁵³ The FTC claimed that these clubs served instead as a means of

³⁴⁵ Ibid 14.

³⁴⁶ Ibid 18.

³⁴⁷ Partnoy 'Is Herbalife a Pyramid Scheme?' June 2014, available at <https://www.theatlantic.com/magazine/archive/2014/06/wall-streets-6-billion-mystery/361624/> (accessed on 18th April 2018).

³⁴⁸ Herbalife 'Prominent Expert Economist and Former FTC Advisor Provides Analysis of the Herbalife Business Model' 22 July 2014 available at <https://www.marketwatch.com/press-release/prominent-expert-economist-and-former-ftc-advisor-provides-analysis-of-the-herbalife-business-model-2014-07-22> (accessed on 9 October 2018).

³⁴⁹ *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 18.

³⁵⁰ Ibid 19.

³⁵¹ Ibid.

³⁵² Ibid 20.

³⁵³ Associated costs include purchasing the products and renting the premises. Ibid 20-21.

recruiting new members.³⁵⁴ If customers became members and then nutrition club owners themselves, the club owner who recruited them could become successful if the new owner purchases products for their club from the original owner.

In relation to the purchasing of products, the FTC stated that distributors were pressured to buy in bulk in order to benefit from greater wholesale discounts.³⁵⁵ Furthermore, Herbalife's buyback policy is subject to the distributor resigning.³⁵⁶ Thus, a distributor cannot return their unsold products and retain their status as a distributor.

Despite Herbalife's statements that income is retail-based, it was established that income was actually dependent on recruitment.³⁵⁷ Sponsors earned money by purchases made by their downline. The importance of recruitment was emphasised by Herbalife in its printed publications. Material such as the *Presentation Book* illustrated how a distributor could earn money through recruiting others who in turn brought in new recruits. This is termed the 'power of duplication'.³⁵⁸ The role of recruitment in Herbalife's compensation plan was also highlighted by one of the members of Herbalife's Founder's Circle during a live presentation in 2009. At the presentation it was stated that royalty was 'the name of the game' and could only be earned through helping other distributors become successful and not through consumers.³⁵⁹ In a Spanish presentation a Herbalife President's team member is reported to have said that 'the only way to scale the ladder of success is through sponsorship'.³⁶⁰

The FTC established that recruitment was the only way in which a distributor could possibly earn a substantial income.³⁶¹ Herbalife compensated its distributors based on the volume of products purchased by their downline and not actual retail sales. Thus, there was an incentive for recruiting new members and to encourage these recruits to purchase a high quantity of products.³⁶²

³⁵⁴ Ibid 21.

³⁵⁵ Ibid 22.

³⁵⁶ Ibid.

³⁵⁷ Ibid 23-24.

³⁵⁸ Ibid 25.

³⁵⁹ Ibid.

³⁶⁰ Ibid.

³⁶¹ Ibid 26.

³⁶² Ibid 29.

The FTC criticised Herbalife's compensation plan commenting that members transcended to higher levels in the organisation and were entitled to rewards based on product purchases as opposed to product sales and these higher levels could only be reached by recruitment.³⁶³ A member's progress was dependent on substantial wholesale product purchases made either personally or by their downline. The Herbalife compensation plan created an incentive for distributors to recruit others because distributors could earn different types of profit from creating a downline.³⁶⁴ In essence, the greater the distributor's downline, the higher they would progress, the greater rewards they would reap. There ought to be a reasonable likelihood that members could derive a profit from the resale of products. However, the FTC found that the majority of Herbalife members made little or no profit from the sale of Herbalife products and some even lost money.³⁶⁵

4.6.3 The outcome of the FTC investigation and its impact on Herbalife

The FTC concluded that Herbalife's practices were unfair because the company incentivised members to purchase products and to enlist others to also purchase products. Advancing in the Herbalife business opportunity was dependent on product purchases and not actual retail demand.³⁶⁶ The FTC concluded that these actions of Herbalife 'cause or are likely to cause substantial injury to consumers that consumers cannot reasonably avoid themselves'.³⁶⁷

In addition, Herbalife was found guilty of income misrepresentation as well as 'false or unsubstantiated claims of income from retail sales', particularly in its marketing and advertising practices.³⁶⁸ These conclusions were reached because the company conveyed the impression that, by joining Herbalife, members were likely to earn a substantial income, however this was often not the case and was seldom

³⁶³ Ibid 30.

³⁶⁴ Ibid 32.

³⁶⁵ Ibid 38.

³⁶⁶ Ibid 39.

³⁶⁷ Ibid.

³⁶⁸ Ibid 39-40.

accompanied by supporting evidence. These misrepresentations contravened the FTC Act because they were deceptive.³⁶⁹

The FTC investigation culminated in a settlement agreement with Herbalife.³⁷⁰ Though the FTC did not conclude that Herbalife was a pyramid scheme *per se*, it did require the company to make certain changes.³⁷¹ In the settlement agreement, Herbalife consented to restructuring its business so that compensation is determined by actual retail sales as opposed to wholesale purchases made by distributors and their downlines. According to the agreement, a minimum of 80% of Herbalife sales needs to be to legitimate end-users, failing which, rewards must be reduced to lower levels. Actual retail sales will be evidenced by receipts and Herbalife will also monitor sales and distribution via a mobile application.³⁷²

The order also required that an Independent Compliance Auditor observe, for seven years, how Herbalife restructures its compensation plan and ascertain whether Herbalife acts in accordance with the structural provisions.³⁷³

In addition, Herbalife was required to pay \$2 million as a form of consumer redress. Cheques were awarded to approximately 350 000 people with the intention of compensating them for financial loss suffered as a result of Herbalife's misleading income representations.³⁷⁴ The company was also precluded from misleading consumers further.

³⁶⁹ Ibid 40.

³⁷⁰ Statement of the Federal Trade Commission *FTC v. Herbalife International of America, Inc* 15 July 2016 available at https://www.ftc.gov/system/files/documents/public_statements/971213/160715herbalifestatement.pdf (accessed on 6 September 2018).

³⁷¹ Cullen 'Herbalife soars after dodging pyramid scheme tag in FTC settlement' 15 July 2016 available at <https://finance.yahoo.com/news/herbalife-soars-dodging-pyramid-scheme-143038125.html?guccounter=1> (accessed on 19th April 2018).

³⁷² Ibid.

³⁷³ Statement of the Federal Trade Commission *FTC v. Herbalife International of America, Inc*. July 15, 2016 available at https://www.ftc.gov/system/files/documents/public_statements/971213/160715herbalifestatement.pdf accessed on 6 September 2018.

³⁷⁴ Practical Law Commercial Transactions 'FTC Mails Redress Checks to Nearly 350,000 Victims of Multi-Level Marketing Scheme' (2018) Practical Law Legal Update w-005-3480 available on Thomson Reuters Westlaw (accessed 7 April 2018).

4.7 Current allegations against Herbalife

Presently, in the United States, there is a federal lawsuit against Herbalife.³⁷⁵ The distributors who instituted legal action claim that Herbalife coerced them into attending numerous events entitled 'Circle of Success' which were costly but which were not 'the secret to wealth' as they purported to be. Herbalife seeks to have the matter dismissed³⁷⁶ or, alternatively, transferred to a court in California.³⁷⁷ According to Herbalife, the distributors did not properly articulate how they were deceived. Herbalife also contends that many of the claims in the present case were addressed in the FTC settlement agreement.³⁷⁸ The plaintiffs disagree claiming that these events were not covered under the FTC investigation.³⁷⁹ The outcome of these newfound allegations has yet to unfold.

4.8 Conclusion

Herbalife's business model and operations appear to be a contentious issue.³⁸⁰ Whilst some are convinced that the company operates a pyramid scheme because of its emphasis on recruitment,³⁸¹ others argue that the Herbalife business opportunity

³⁷⁵ Fin 24 'Herbalife distributors claim in \$1 billion lawsuit that 'success' events were a sham' 21 August 2018 available at <https://www.fin24.com/Economy/herbalife-distributors-claim-in-1-billion-lawsuit-that-success-events-were-a-sham-20180821> (accessed on 11 October 2018).

³⁷⁶ House 'Herbalife facing new class action lawsuit from disgruntled distributors' 21 August 2018 available at <https://seekingalpha.com/news/3384570-herbalife-facing-new-class-action-lawsuit-disgruntled-distributors> (accessed on 11 October 2018).

³⁷⁷ On August 23rd 2018, it was ordered that the matter be divided into two parts with claims against independent distributors being heard in Miami whilst action against the company as a whole proceeds in California. However, the order was subsequently appealed with proceedings stayed in the interim. Information regarding this can be found on the Behind MLM website available at <https://behindmlm.com/companies/herbalife/some-herbalife-distributors-get-arbitration-venue-change-to-california/> (accessed on 21 January 2019).

³⁷⁸ House 'Herbalife facing new class action lawsuit from disgruntled distributors' 21 August 2018 available at <https://seekingalpha.com/news/3384570-herbalife-facing-new-class-action-lawsuit-disgruntled-distributors> (accessed on 11 October 2018).

³⁷⁹ Information regarding this can be found on the Behind MLM website available at <https://behindmlm.com/companies/herbalife/herbalife-circle-of-success-event-fraud-targeted-in-class-action/> (accessed on 21 January 2019).

³⁸⁰ Conversano 'The War Against Herbalife: Pyramid Scheme or Multi-Level Marketing Master?' 2015 available at http://www.fraudconference.com/uploadedFiles/Shared_Content/Course_Materials/26th/ppt/9A-James-Conversano.pdf (accessed on 9 October 2018).

³⁸¹ See for example Multilevel Marketing: Last Week Tonight with John Oliver (HBO) available at <https://www.youtube.com/watch?v=s6MwGeOm8il> accessed on 21 February 2018 and Thomson Reuters 'Ackman calls Herbalife a 'pyramid scheme'' 20 December 2012 available at

bears semblance to that of a legitimate MLM firm.³⁸² Those who favour the latter view cite Herbalife's buyback policy, discouragement of inventory loading, minimal start-up costs and offering of legitimate products with real value, in support of their argument.

Herbalife denied the complaints and allegations made against it.³⁸³ These allegations were subsequently addressed by the FTC in its investigation.³⁸⁴ The FTC ultimately held that Herbalife was not a pyramid scheme, however, the outcome was not all that favourable for Herbalife. The FTC found that the company was guilty of misleading its members by misrepresenting to them the income they could potentially earn. In addition, recruitment was essential to a Herbalife distributor's progress in the company. This led the FTC to conclude that Herbalife was not a viable retail-based opportunity and that Herbalife's actions and conduct amounted to a contravention of section 5 of the FTC Act.³⁸⁵ Consequently, Herbalife entered into a settlement agreement with the FTC in terms of which it consented to making changes to its compensation structure, to discontinue misleading consumers and to pay \$2 million to Herbalife members who had been misled and suffered financial loss as a result thereof. To ensure compliance with the settlement agreement, the FTC also ordered that, for seven years, an Independent Compliance Auditor must monitor how Herbalife restructures its compensation plan.³⁸⁶ As of late, there have been further allegations against Herbalife with distributors alleging misrepresentation on the part of

<https://business.financialpost.com/investing/ackman-calls-herbalife-a-pyramid-scheme> (accessed on 20 October 2018).

³⁸² Coughlan 'Assessing an MLM Business: Herbalife as a Legitimate MLM' July 2012 available at https://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/Assessing%20an%20MLM%20Business%20HLF%20as%20a%20Legit%20MLM%207-30-2012%20FINAL.pdf (accessed on 18 July 2018).

³⁸³ Herbalife 'Herbalife Statement in Response to Ackman Presentation' 20 December 2012 available at <https://ir.herbalife.com/news-releases/news-release-details/herbalife-statement-response-ackman-presentation> (accessed on 9 October 2018).

³⁸⁴ *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016.

³⁸⁵ Ibid.

³⁸⁶ Statement of the Federal Trade Commission *FTC v. Herbalife International of America, Inc* 15 July 2016 available at https://www.ftc.gov/system/files/documents/public_statements/971213/160715herbalifestatement.pdf (accessed on 6 September 2018).

Herbalife.³⁸⁷ However, insofar as the new allegations are concerned, it remains to be seen what transpires.

³⁸⁷ House 'Herbalife facing new class action lawsuit from disgruntled distributors' 21 August 2018 available at <https://seekingalpha.com/news/3384570-herbalife-facing-new-class-action-lawsuit-disgruntled-distributors> (accessed on 11 October 2018).

Chapter 5

Herbalife under South African law

5.1 Introduction

Herbalife began in South Africa in 1995 where it continues to operate.³⁸⁸ This Chapter will analyse Herbalife's Sales and Marketing Plan in light of the relevant CPA provisions as set out in Chapter 3. Thereafter Herbalife will be viewed under the common law concept of fraud.

5.2 Herbalife in South Africa

According to the South African Herbalife Statement of Average Gross Compensation for 2017,³⁸⁹ South African Herbalife distributors can generate an income in two ways namely; they can profit from their own sales and multilevel compensation.³⁹⁰ Apart from this, the South African website does not provide detailed information regarding how members are compensated. However, the Statement of Average Gross Compensation incorporates, by reference, the United States Herbalife Sales and Marketing Plan. For this reason, the compensation and commission structure as detailed in Chapter 4 will be examined in the light of South African law.

5.3 Herbalife and section 43 of the CPA

According to the definition of pyramid scheme provided by section 43(4), a business plan will constitute a pyramid scheme when participants earn money primarily from recruitment rather than actual retail sales or, alternatively, during the promotion of the

³⁸⁸ Majola and Dini 'All that glitters: an exploration of the Pyramid Scheme and Ponzi Scheme phenomena and what the law is doing to protect consumers' 15 July 2015 available at <https://www.lexology.com/library/detail.aspx?g=c62b13a4-d053-48d5-bef2-3b1ac7a85351> (accessed on 21 February 2018).

³⁸⁹ Herbalife 'Statement of Average Gross Compensation Paid by Herbalife Nutrition to South Africa Members in 2017' 26 February 2018 available at https://edge.myherbalife.com/vmba/media/1A246934-C8ED-4C07-9E56-3DB0AA8F8561/Web/General/Original/SAGC_South%20Africa.pdf (accessed on 21 November 2018).

³⁹⁰ The concepts profit on own sales and multilevel compensation have already been explained in Chapter 4.

scheme, recruitment is emphasised as being essential to compensation. As acknowledged by the FTC, Herbalife's Sales and Marketing Plan incentivised recruitment because it rewarded upline distributors for wholesale product purchases made by their downline.³⁹¹ Progress in the compensation hierarchy depended on recruitment and not retail sales.³⁹² Herbalife continues to reward its members for wholesale purchases made by their downline. In 2017, 1 045 non-sales leaders in South Africa earned wholesale profit for downline purchases from Herbalife itself together with 5 016 sales leaders with a downline.³⁹³ However, following the FTC investigation, there has been an increase in product sales to legitimate end users.

In February 2017, Herbalife stated that approximately 60% of its sales were to legitimate end users and during April 2017,³⁹⁴ this figure increased to more than 70%.³⁹⁵ The company has since reached the threshold requirement of 80% of sales to legitimate end users as set out in its consent agreement concluded with the FTC.³⁹⁶ Despite this, if Herbalife members earn more money via recruitment than via these external sales, Herbalife will fit the South African definition of a pyramid scheme.

The definition of a pyramid scheme set out in section 43(4) contains two parts. Thus, even if recruitment is not the primary means through which Herbalife distributors earn money, Herbalife may still amount to a pyramid scheme if it is promoted in a manner that emphasises that recruitment is essential to compensation. This is because of section 43(4)(b) which makes it unlawful for an arrangement, agreement, practice or scheme to be promoted in this way.

³⁹¹ *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 4.

³⁹² *Ibid* 30.

³⁹³ Herbalife 'Statement of Average Gross Compensation Paid by Herbalife Nutrition to South Africa Members in 2017' 26 February 2018 available at https://edge.myherbalife.com/vmba/media/1A246934-C8ED-4C07-9E56-3DB0AA8F8561/Web/General/Original/SAGC_South%20Africa.pdf (accessed on 21 November 2018).

³⁹⁴ This information was revealed at Herbalife's fourth-quarter and full-year 2016 earnings conference, the transcript of which is available at <https://ir.herbalife.com/static-files/59bc9e2f-2795-481c-b575-564163e39191> (accessed on 21 November 2018).

³⁹⁵ This information was revealed at Herbalife's First Quarter 2017 Earnings Conference Call, the transcript of which is available at <https://ir.herbalife.com/static-files/3cd33d81-9dde-4ad0-bc6b-745563628e4f> (accessed on 21 November 2018).

³⁹⁶ Milkweed 'Herbalife Compliance Issues' 20 November 2018 available at <https://seekingalpha.com/article/4223696-herbalife-compliance-issues?page=3> (accessed on 21 November 2018).

As noted by the FTC, Herbalife live presentations, as well as promotional material that existed in print and video form, stressed the importance of recruitment, discussed the 'power of duplication', and in one instance went as far as saying that, 'the only way to scale the ladder of success is through sponsorship'.³⁹⁷ This form of advertising will fall under the latter part of the section 43(4) definition of a pyramid scheme. Engaging in the promotion of such scheme, as well as participating therein, amounts to prohibited conduct under section 43(2)(b) of the CPA. The Herbalife South Africa website does, however, contain a disclaimer warning against the scheme being promoted in a manner that emphasises recruitment and it also acknowledges the illegality thereof.³⁹⁸

Furthermore, in the event that Herbalife is not a pyramid scheme by definition, it may still be classified as a prohibited scheme. The Minister of Trade and Industry may, by virtue of sections 43(2)(d) and 43(6), declare Herbalife as being a prohibited scheme if he is of the opinion that its nature or effect is similar to that of a pyramid scheme. However, even if Herbalife restructures its compensation plan so that it does not resemble a pyramid scheme, or such that its nature and effect is not similar to that of a pyramid scheme, it may still fall foul of other sections of the CPA.

5.4 Herbalife and section 40 of the CPA

An interpretation of section 40 of the CPA leads to the conclusion that neither Herbalife nor any of its distributors must knowingly or unknowingly act unethically or improperly when dealing with a consumer. It is prohibited conduct for them to engage in any conduct listed in section 40. Of particular relevance is coercion, duress and pressure.

As discussed in Chapter 4, one of the criticisms of Herbalife's Sales and Marketing Plan is the promotional vacations which the company offers. To qualify for these vacations, downline distributors are pressurised to buy many products.³⁹⁹ Section

³⁹⁷ *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 25.

³⁹⁸ The disclaimer reads as follows, '[w]hen considering or comparing business opportunities please be aware that it is illegal for a promoter or participant in a trading scheme to persuade anyone to make a payment by promising benefits from getting others to join a scheme. Do not be misled by claims that high earnings are easily achieved' and can be found on the South African website available at <http://businessopportunity.herbalife.co.za/> (accessed on 21 November 2018).

³⁹⁹ Criticisms about Herbalife's compensation plan can be found on the Facts About Herbalife website available at <https://www.factsabouth Herbalife.com/the-facts/the-herbalife-compensation-plan/> (accessed on 8 November 2018).

40(1) of the CPA includes pressure as a form of unconscionable conduct. However, as mentioned in Chapter 3, it is difficult to determine when pressure will amount to unconscionable conduct that cannot be covered under any of the other section 40(1) grounds.⁴⁰⁰ It can thus be argued that this kind of pressure placed upon Herbalife distributors fits the definition of coercion. The same can be said in the following situation. The FTC was alert to the fact that Herbalife forced distributors to buy products in bulk so that they could benefit from greater wholesale discounts.⁴⁰¹ Although the FTC found that this amounted to pressure, it is possible that, under section 40 of the CPA, such conduct would constitute coercion.

Moreover, the current pending litigation against Herbalife in the United States is centred around the allegation that Herbalife coerced members into attending numerous 'Circle of Success' events.⁴⁰² If these allegations have any merit, this will also amount to unconscionable conduct, in the form of coercion, under the CPA. Owing to the similarity between the definition of coercion and duress, Herbalife's conduct in the different situations discussed above could possibly also fall under duress.

Section 40(2) of the CPA is similar to section 5 of the FTC Act.⁴⁰³ Section 40(2) precludes Herbalife distributors from consciously taking advantage of a consumer who is substantially incapable of protecting their own interests. One reason for this may be a consumer's ignorance. If the consumer is uneducated in general or uneducated about the Herbalife business opportunity, and the distributor, who despite being aware of this fact uses it to their own benefit, this could amount to unconscionable conduct.

Although sections 40(1) and 40(2) provide a list of conduct that is considered unconscionable, this list is not exhaustive, hence, Herbalife and its representatives need to abstain from all forms of unethical and improper conduct.

⁴⁰⁰ Du Plessis 'Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008' (2012) 75 *THRHR* 29.

⁴⁰¹ *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 22.

⁴⁰² Fin 24 'Herbalife distributors claim in \$1 billion lawsuit that 'success' events were a sham' 21 August 2018 available at <https://www.fin24.com/Economy/herbalife-distributors-claim-in-1-billion-lawsuit-that-success-events-were-a-sham-20180821> (accessed on 11 October 2018).

⁴⁰³ According to section 5 of the FTC Act, 'an act or practice is unfair where it (1) causes or is likely to cause substantial injury to consumers, (2) cannot be reasonably avoided by consumers and (3) is not outweighed by countervailing benefits to consumers or to competition'.

5.5 Herbalife and sections 29, 41 and 48 of the CPA

Like section 40, section 41 of the CPA bears similarity to section 5 of the FTC Act. In order to ensure compliance with sections 29 and 41 of the CPA, neither Herbalife nor its distributors must convey false, misleading or deceptive representations to consumers whilst marketing Herbalife products. Furthermore, section 41(1)(c) read with section 41(2)(b) mandates that they correct any misapprehension which consumers have which can be construed as being a false, misleading or deceptive representation.

A major flaw in Herbalife's Sales and Marketing Plan, as pointed out by the FTC, was the representations it gave distributors regarding their financial prospects of success. The various forms of marketing and promotional material used by the company led distributors to believe that they could earn a significant income either part-time or full time.⁴⁰⁴ This differed from reality where only a few distributors benefitted substantially whilst most generated only a small income (if at all) or experienced a loss.⁴⁰⁵ Herbalife's 2017 Statement of Average Gross Compensation contains a disclaimer regarding potential earnings.⁴⁰⁶ However, as noted by the FTC in its investigation, these disclaimers do not change the general message portrayed by Herbalife, that is, that its members can earn a substantial income.⁴⁰⁷

Herbalife also created the impression that distributors earn a significant income from the sale of Herbalife products.⁴⁰⁸ This can be regarded as a false representation because, as discussed previously, the main source of a distributor's income stems from recruitment.⁴⁰⁹ However, in light of the fact that Herbalife has since placed a

⁴⁰⁴ *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 4-5.

⁴⁰⁵ *Ibid* 38.

⁴⁰⁶ The disclaimer reads as follows, '[t]he compensation summarized below is not necessarily representative of the compensation, if any, that any particular Member will receive. These figures should not be considered as guarantees or projections of your actual compensation or profits. Success with Herbalife Nutrition results only from successful product sales efforts, which require hard work, diligence and leadership. Your success will depend upon how effectively you exercise these qualities'.

⁴⁰⁷ *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 5.

⁴⁰⁸ *Ibid* 14.

⁴⁰⁹ *Ibid* 26.

greater focus on retail sales by complying with the 80% threshold set by the FTC, it can be argued that this representation is no longer inaccurate.⁴¹⁰

Another way in which Herbalife members are deceived or misled is through the promotion of nutrition clubs. Members are given the idea that nutrition clubs earn a substantial sum of money for the club owner, however, the FTC investigation revealed otherwise.⁴¹¹

Owing to the discrepancy between what Herbalife asserted and what actually transpired, the abovementioned claims could be viewed as false, deceptive or misleading representations under section 41 of the CPA. In terms of section 48 of the CPA, if there is a false, misleading or deceptive representation by Herbalife or its distributors which a consumer acts upon to their detriment, the resulting contract will be unfair, unreasonable or unjust. A contract between Herbalife and a consumer will also be unfair, unreasonable or unjust if Herbalife or its distributors make a statement of opinion and the consumer's reliance thereon negatively impacts upon them.⁴¹² If the contract is as a result of unconscionable conduct or false, misleading or deceptive representations, the consumer can approach a civil court.⁴¹³ If the court finds that the consumer's allegations are correct, it will decide on an appropriate remedy such as ordering Herbalife to restore the consumer's money as well as recompense the consumer for any loss suffered.⁴¹⁴

5.6 The consequences Herbalife can face if it engages in prohibited conduct

It is the responsibility of the NCC to investigate any complaint it receives which alleges that Herbalife is engaging in prohibited conduct stipulated in sections 43, 40 or 41. Should the NCC find these allegations to be correct, it may issue a compliance notice to Herbalife.⁴¹⁵ The notice will stipulate how Herbalife has breached the CPA and how

⁴¹⁰ Milkweed 'Herbalife Compliance Issues' 20 November 2018 available at <https://seekingalpha.com/article/4223696-herbalife-compliance-issues?page=3> (accessed on 21 November 2018).

⁴¹¹ *Federal Trade Commission v Herbalife International of America Inc* Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 20.

⁴¹² Section 48(2)(c).

⁴¹³ Section 52.

⁴¹⁴ Section 52(3).

⁴¹⁵ Section 100(1).

Herbalife can rectify this, usually within a specified time.⁴¹⁶ Alternatively, within the specified time, Herbalife can bring forth reasonable evidence indicating that it did not engage in conduct prohibited under the CPA.⁴¹⁷

Should Herbalife fail to act in accordance with the notice, the matter can be referred to either the NPA for prosecution or the NCT. The NCT has the power to impose an administrative fine.⁴¹⁸ The orders which the NCT can make if Herbalife is found guilty of engaging in a prohibited practice under the CPA are those set out in section 150 of the National Credit Act.⁴¹⁹ This includes declaring Herbalife's conduct as prohibited, issuing an interdict against Herbalife and imposing an administrative fine on Herbalife. The fine can be equivalent to 10% of Herbalife's annual turnover in the previous year or R1 000 000, whichever amount is higher.⁴²⁰ Herbalife's failure to comply with an NCT order may result in a fine or imprisonment for not more than 10 years or both.⁴²¹

5.7 Herbalife and the common law

In addition to section 41 of the CPA, the common law also precludes Herbalife from making misrepresentations. If Herbalife makes a false representation, the purpose of which is to defraud consumers, and which prejudices or which can prejudice consumers, then Herbalife's conduct will be tantamount to the common law definition of fraud. Herbalife's inaccurate statements regarding the potential earnings its members could expect to receive can be regarded as being prejudicial or potentially prejudicial because it was contrary to reality where the business opportunity was profitable to only a few while most derived no profits or incurred a loss. If Herbalife members joined the company because they were misled by these fraudulent

⁴¹⁶ Moodley-Isaacs 'How the consumer law will be enforced' 24 January 2011 available at <https://www.iol.co.za/personal-finance/how-the-consumer-law-will-be-enforced-1016167> (accessed on 29 November 2018).

⁴¹⁷ Ibid.

⁴¹⁸ Havenga ... et al *General Principles of Commercial Law* 7 ed (2010) 508.

⁴¹⁹ Act 34 of 2005. The NCT was established by the National Credit Act (NCA) and its powers and functions were extended when the CPA came into operation in 2011. Therefore, in order to ascertain the powers and functions of the NCT it is necessary to consider the relevant sections of the NCA as these are not re-iterated in the CPA.

⁴²⁰ Section 151(2) of the NCA and section 112(2) of the CPA.

⁴²¹ Section 160 read with section 161 of the NCA.

representations, they are entitled, under the common law, to take legal action against Herbalife and to claim damages.⁴²²

5.8 Conclusion

It is apparent that the manner in which Herbalife operates in South Africa mimics its operation in the United States. Under South African law, Herbalife is prohibited from operating a pyramid scheme. An analysis of Herbalife's Sales and Marketing Plan through the lens of the CPA leads to the conclusion that Herbalife's focus on incentivising recruitment, as opposed to retail sales, prior to the FTC investigation, would render it a pyramid scheme under the section 43(4)(a) definition. However, Herbalife has since increased its retail sales to external consumers to over 80%. Nevertheless, by promoting the Herbalife opportunity in a manner that emphasises recruitment and by determining a member's progress and compensation based on recruitment, Herbalife can still amount to a pyramid scheme under section 43(4)(b). However even if the NCC, following an investigation into Herbalife, finds otherwise, Herbalife is unlikely to escape liability. This is because the NCC is entitled to investigate all forms of prohibited conduct and not just the promotion of, and participation in, pyramid schemes.

Herbalife's conduct and representations made while promoting the scheme and attempting to enlist new members may constitute unconscionable conduct under section 40 of the CPA and/or false, misleading or deceptive representations under section 41. As with all forms of prohibited conduct investigated by the NCC, Herbalife may be issued a compliance notice. Failure to adhere thereto may have further consequences as the matter may then be prosecuted by the NPA. Alternatively, the NCT may impose an administrative fine on Herbalife.

⁴²² Melville *The Consumer Protection Act made easy* 2 ed (2011) 55.

CHAPTER 6

CONCLUSION AND RECOMMENDATIONS

6.1 Conclusion

This research was undertaken with the intention of determining whether Herbalife is a legitimate MLM company or an illegal pyramid scheme under South African law, which has specific legislation dealing with pyramid schemes. The reason for embarking on this research stems from the numerous allegations against Herbalife in other jurisdictions, most notably the United States, where the FTC declared Herbalife to be a legitimate business model but ordered that certain changes be made and that consumers who had been misled be compensated.

This research has demonstrated that there is a very fine line between legitimate MLM companies and illegal pyramid schemes, especially when a legitimate product is involved, and it is in this case not easy to make a definitive finding one way or the other. This is also demonstrated by the NCC's inability to make findings on so many of the schemes that it has commenced investigating.⁴²³ It is evident from this research that Herbalife does sell legitimate products which are beneficial to consumers, particularly athletes and those seeking to maintain a healthy lifestyle. The cost of Herbalife Member Packs is also, arguably, reasonable and proportionate to what members receive in return, namely, the packs themselves and the opportunity to pursue the business opportunity. Furthermore, Herbalife adopts a buyback policy. These features of Herbalife's business model indicate that Herbalife really does resemble an MLM. However, there are other aspects of the business model which are questionable, particularly the issues around the compensation plan and the amount of money that can be made from participating in the scheme.

To amount to a pyramid scheme under the CPA, an arrangement, agreement, practice or scheme must compensate its participants primarily for recruitment, or, while promoting, it must emphasise that recruitment is the primary form of compensation.

⁴²³ Information regarding the NCC's decision to decline reporting on certain schemes which it had investigated can be found on the Behind MLM website available at <https://behindmlm.com/companies/world-ventures/nccs-worldventures-findings-will-not-be-made-public/> (accessed on 10 January 2019).

Majority of Herbalife's product sales (about 80%) is to consumers who are not Herbalife recruits.⁴²⁴ Furthermore, the South African Herbalife website expressly warns against the promotion of Herbalife in a way that emphasises recruitment.⁴²⁵ It can thus be concluded that Herbalife does not conform to the section 43 definition of a pyramid scheme hence, it is not a prohibited scheme under the CPA. However, even though Herbalife may avoid being termed a pyramid scheme, it may not escape liability altogether. By misrepresenting to members the income they can expect to receive and by pressurising recruits to purchase products or attend events under the misapprehension that this will better their income, Herbalife is guilty of engaging in other forms of conduct deemed prohibited by the CPA.

6.2 Recommendations

The following recommendations are proposed:

- In order to remain clear of being labelled a pyramid scheme, Herbalife must strive to maintain the threshold requirement of 80% of sales to external consumers thereby attempting to ensure that members receive more money from retail sales as opposed to recruitment. Furthermore, during promotion of the scheme, retail sales, and not recruitment, must be emphasised as being the main source of a member's income.
- Herbalife must proceed cautiously and be mindful of how it promotes its business opportunity to potential recruits so as to ensure that it is not engaging in other forms of proscribed conduct. The company must be clear in the message it sends out and make certain that, going forward, it makes accurate representations and provides recruits with a realistic expectation of their potential earnings. This can be done by keeping records and furnishing recruits with these records to enable them to make an informed decision regarding whether or not to join the Herbalife opportunity.

⁴²⁴ Milkweed 'Herbalife Compliance Issues' 20 November 2018 available at <https://seekingalpha.com/article/4223696-herbalife-compliance-issues?page=3> (accessed on 21 November 2018).

⁴²⁵ The warning, which is in the form of a disclaimer, is available at <http://businessopportunity.herbalife.co.za/> (accessed on 21 November 2018).

The Herbalife company enjoys global success, however, its existence in South Africa may come to an untimely demise if it promotes its business opportunity in a manner that is tantamount to prohibited conduct under the CPA.

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Annexure A: Ethical Clearance Certificate



3 September 2018

Miss Johara Deen Ally 214547721
School of Law
Howard College Campus

Dear Miss Ally

Protocol reference number: HSS/1412/018M

Project title: A critical examination of Herbalife's business model in order to determine whether it is a prohibited scheme under the Consumer Protection Act 68 of 2008

FULL APPROVAL – No Risk/Exemption Application

In response to your application received 2 August 2018, the Humanities & Social Sciences Research Ethics Committee has considered the abovementioned application and the protocol has been granted **FULL APPROVAL**.

Any alteration/s to the approved research protocol i.e. Questionnaire/Interview Schedule, Informed Consent Form, Title of the Project, Location of the Study, Research Approach and Methods must be reviewed and approved through the amendment /modification prior to its implementation. In case you have further queries, please quote the above reference number.

PLEASE NOTE: Research data should be securely stored in the discipline/department for a period of 5 years.

The ethical clearance certificate is only valid for a period of 3 years from the date of issue. Thereafter Recertification must be applied for on an annual basis.

I take this opportunity of wishing you everything of the best with your study.

Yours faithfully

.....
Professor Shenuka Singh (Chair)
Humanities & Social Sciences Research Ethics Committee

/pm

cc Supervisor: Professor TA Woker
cc. Academic Leader Research: Dr Shannon Bosch
cc. School Administrator: Ms Robynne Louw/ Mr P Ramsewak

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